GOVERNMENTAL LEASING TAX ACT OF 1983

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

H.R. 3110

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO DENY CERTAIN TAX INCENTIVES FOR PROPERTY USED BY GOVERNMENTS AND OTHER TAX-EXEMPT ENTITIES

JUNE 8, 1983

Serial 98-26

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
25-107 O WASHINGTON : 1983

H781-40.

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GOVERNMENTAL LEASING TAX ACT OF 1983

WEDNESDAY, JUNE 8, 1983

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearing and a copy of the bill, H.R. 3110, follow:]

[Press release of Wednesday, May 25, 1983]

Hon. Dan Rostenkowski (D., Ill.,) Chairman, Committee on Ways and Means, U.S. House of Representatives, Announces Hearings on H.R. 3110, the Governmental Leasing Tax Act of 1983

Hon. Dan Rostenkowski (D., Ill.,) Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold hearings on H.R. 3110, introduced by Congressmen Pickle, Rangel, Vander Jagt, Frenzel, Stark, Gradison, Duncan, Pease, Dorgan and Martin of North Carolina, the Governmental Leasing Tax Act of 1983. The hearing will be held on Wednesday, June 8, 1983 at 10:00 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building.

I. BACKGROUND

Governments and other tax-exempt entities have recently engaged in the sale and leaseback of buildings, and other transactions, that permit private investors to claim tax benefits that would not exist if the property were both owned and used by the tax-exempt entity. Some of these tax benefits are shared with the tax-exempt entity through the terms of the sale-leaseback or other arrangement. This practice has been increasing rapidly in response to recently enacted liberalizations of depreciation and the investment tax credit.

On February 28, 1983, the Subcommittee on Oversight conducted a public hearing on the tax aspects and policy issues related to leasing arrangements by the Federal Government and other nontaxable entities. The purpose of the hearing was to obtain information on leasing practices by nontaxable entities and to examine related tax and budget policy issues. On the basis of these hearings, the Subcommittee today adopted a report to the full Committee including a number of findings and recommendations. Among these are the following:

Federal Government long-term leasing of major assets is more costly than purchase of the same assets.

Congressional intent regarding the availability of the investment tax credit for lessors who lease property to the Federal Government or other nontaxable entities for tax-exempt activities should be clarified.

Congress should reexamine cost recovery deductions for lessors who enter into long-term lease transactions or similar arrangements with the Federal Government or other nontaxable entities.

II. SCOPE OF THE HEARING

The Committee invites testimony on the report of the Subcommittee on Oversight regarding leasing by the Federal Government and other tax-exempt entities. The

Committee also invites testimony on H.R. 3110, the Governmental Leasing Tax Act of 1983.

In announcing the hearing, Chairman Rostenkowski stated that: "The depreciation and investment tax credit provisions of the tax code were never intended as a mechanism for subsidizing State and local governments, colleges, universities and other tax-exemp entities. I am alarmed by recent accounts of saleleaseback transactions for existing buildings such as museums, city halls, and basketball arenas. Federal agencies have also entered into lease contracts for ships and satellites that will prove to be more expensive than simple purchase even if particular agencies are thereby able to shift some of their budget costs over to the Treasury in the form of revenue losses. I expect the Committee to review throughly these issues and to consider the appropriateness of the legislative response contained in H.R. 3110."

III. DESCRIPTION OF H.R. 3110

In general, H.R. 3110 would require straight-line depreciation over extended recovery periods for property used by tax-exempt entities and would tighten the present law denial of investment credits for this property.

Depreciation provisions

The bill would require that depreciation deductions for property used by tax-exempt entities be computed by using the straight-line method and the following extended recovery periods: 5 years for property in the 3-year class; 12 years, in the 5-year class; 25 years, in the 10-year class; and 35 years, in the 15-year public utility class and the 15-year real property class.

Depreciation deductions for mass commuting vehicles eligible for safe-harbor lease treatment under present law would not be affected by the bill.

Investment credit provisions

The bill would extend the present law denial of the investment credit for property used by certain tax-exempt entities to cover property used by any foreign person (when income from the property is not subject to U.S. tax), any foreign government, any international organization and any possession of the United States; and property used pursuant to a contract that purports to be a service contract but is more property treated as a lease.

The bill would allow the rehabilitation credit for qualified rehabilitation expenditures for buildings leased to tax-exempt entities (as under present law), but not where the building or rehabilitation expenditure has been financed by a tax-exempt industrial development bond.

Effective dates

In general, the bill would apply to property placed in service by the taxpayer after May 23, 1983.

The bill would not apply to property used pursuant to binding contracts which on May 23, 1983, and thereafter required the taxpayer to acquire, construct, reconstruct, or rehabilitate the property and required the tax-exempt entity to use it. This exception would apply to property used by the United States government only if it is placed in service before January 1, 1984.

Details for submission of requests to be heard:

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-3627] no later than close of business, Thursday, June 2, 1983, to be followed by a formal written request to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This procedure will afford more time for members to question witnesses. In order to expedite the hearing, witnesses may be grouped as panelists with strict time limitations for each panelist.

Each statement to be presented to the Committee or any written statement submitted for the record must contain the following information:

1. The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);
2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of comments and recommendations.

Written statements in lieu of personal appearance:

For those who wish to file a written statement for the printed record of the hearing, six copies are required and may be submitted to the Committee office by the close of business Friday, June 10, 1983, to John J. Salmon, Chief Counsel, Room 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statement distributed to the press and the interested public, they may provide additional copies for this purpose to the Committee office before the hearing begins.

98TH CONGRESS
1ST SESSION

H. R. 3110

To amend the Internal Revenue Code of 1954 to deny certain tax incentives for property used by governments and other tax-exempt entities.

IN THE HOUSE OF REPRESENTATIVES

MAY 24, 1983

Mr. PICKLE (for himself, Mr. RANGEL, Mr. VANDER JAGT, Mr. FRENZEL, Mr. STARK, Mr. GRADISON, Mr. DUNCAN, Mr. PEASE, Mr. DORGAN, and Mr. MARTIN of North Carolina) introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to deny certain tax incentives for property used by governments and other tax-exempt entities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. DENIAL OF TAX INCENTIVES FOR PROPERTY USED BY GOVERNMENTS AND OTHER TAX-EXEMPT ENTITIES.

(a) GENERAL RULE.—Subsection (f) of section 168 of the Internal Revenue Code of 1954 (relating to special rules for application of accelerated cost recovery system) is amended by redesignating paragraph (13) as paragraph (14) and by inserting after paragraph (12) the following new paragraph:

"(13) PROPERTY USED BY GOVERNMENTS AND OTHER TAX-EXEMPT ENTITIES.—

"(A) IN GENERAL.—Notwithstanding any other provision of this section, the deduction allowed under subsection (a) (and any other deduction allowable for depreciation or amortization) for any taxable year with respect to tax-exempt use property shall be determined—

"(i) by using the straight-line method (without regard to salvage value), and

"(ii) by using a recovery period determined under the following table:

"In the case of:	The recovery period shall be:
3-year property	5 years
5-year property	12 years
10-year property	25 years
15-year public utility property	35 years
15-year real property	35 years

"(B) OPERATING RULES.—

"(i) CONVENTION.—In the case of property other than 15-year real property, the half-year convention shall apply for purposes of subparagraph (A). In the case of 15-year real property, the amount determined under subparagraph (A) shall be determined on the basis of the number of months in the year in which the property is in service.

"(ii) EXCEPTION WHERE LONGER RECOVERY PERIOD APPLICABLE.—Subparagraph (A) shall not apply to any recovery property if the recovery period which would be applicable to such property by reason of an election under subsection (b)(3) exceeds the recovery period for such property determined under subparagraph (A)(ii).

"(iii) SPECIAL RULE FOR PROPERTY WHICH IS NOT RECOVERY PROPERTY.—In the case of any property which is not recovery property, for purposes of this paragraph, the determination of the class in which such property falls shall be made as if such property were recovery property, and

"(iv) COORDINATION WITH PARAGRAPH (12).—Paragraph (12) shall not apply to any property to which this paragraph applies.

"(C) TAX-EXEMPT USE PROPERTY.—For purposes of this paragraph—

"(i) PROPERTY OTHER THAN 15-YEAR REAL PROPERTY.—

"(I) IN GENERAL.—Except as otherwise provided in this paragraph, the term 'tax-exempt use property' means any property used by a tax-exempt entity.

"(II) EXCEPTION IN THE CASE OF CERTAIN SHORT-TERM OR CASUAL LEASES.—For purposes of subclause (I), property shall not be treated as used by a tax-exempt entity merely by reason of use pursuant to a casual or short-term lease.

"(ii) 15-YEAR REAL PROPERTY.—In the case of 15-year real property, the term 'tax-exempt use property' means any property to the extent used by a tax-exempt entity where—

"(I) the property was financed in whole or in part by obligations the interest on which is exempt from tax under section 103 and such entity (or a related entity) participated in such financing,

"(II) such use is pursuant to a lease under which there is a fixed price purchase or sale option which involves such entity (or a related entity),

"(III) the entity (or a related entity) directly or indirectly protects the lessor from loss on his investment in the property so used, or

"(IV) such use occurs after a sale or lease of the property by such entity (or a related entity) and a leaseback.

Such term shall not include any property (or portion thereof) unless more than 20 percent of the use of such property consists of use described in the preceding sentence.

"(iii) EXCEPTION WHERE PROPERTY USED IN UNRELATED TRADE OR BUSINESS.—The term 'tax-exempt use property' shall not include any portion of a property predominately used by the tax-exempt entity in an unrelated trade or business the income of which is subject to tax under section 511.

"(D) TAX-EXEMPT ENTITY.—For purposes of this paragraph, the term 'tax-exempt entity' means—

"(i) the United States, any State or political subdivision thereof, any possession of the United States, any foreign government, any international organization, or any agency or instrumentality of any of the foregoing,

"(ii) an organization (other than a cooperative described in section 521) which is exempt from tax imposed by this chapter, and

"(iii) any person who is not a United States person (but only with respect to property the income derived from the use of which is not subject to tax under this chapter).

"(E) TREATMENT OF CERTAIN CONTRACTS FOR PROVIDING SERVICES.—For purposes of this paragraph and paragraphs (4) and (5) of section 48(a), a contract which purports to be a service contract shall not be treated as a service contract if such contract is more properly treated as a lease of property (taking into account all relevant factors including whether or not such entity controls the property or such entity has a significant possessory or economic interest in the property)."

(b) DENIAL OF INVESTMENT TAX CREDIT FOR PROPERTY USED BY FOREIGN GOVERNMENTS AND OTHER FOREIGN PERSONS.—Paragraph (5) of section 48(a) of such

Code (relating to property used by governmental units) is amended by striking out the first sentence and inserting in lieu thereof the following:

"Property used—

"(A) by the United States, any State or political subdivision thereof, any possession of the United States, any foreign government, any international organization, or any agency or instrumentality of any of the foregoing, or

"(B) by any person who is not a United States person (but only with respect to property the income derived from the use of which is not subject to tax under this chapter),

shall not be treated as section 38 property."

(c) REHABILITATION CREDIT NOT TO APPLY TO EXPENDITURES FINANCED BY TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS.—

(1) IN GENERAL.—Subparagraph (B) of section 48(g)(2) of such Code (relating to certain expenditures not treated as qualified rehabilitation expenditures) is amended by adding at the end thereof the following new clause:

"(vi) TAX-EXEMPT FINANCING.—Any expenditures in connection with the rehabilitation of a building if any portion of—

"(I) the cost of acquiring such building or any interest therein, or

"(II) the expenditures in connection with such rehabilitation,

is financed (directly or indirectly) by the proceeds of an industrial development bond (within the meaning of section 103(b)(2)) the interest on which is exempt from taxation under section 103(a)."

(2) TECHNICAL AMENDMENT.—Clause (i) of section 48(g)(2)(B) of such Code is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply to any expenditure to the extent paragraph (12) or (13) of section 168(f) applies to such expenditure."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to property placed in service by the taxpayer after May 23, 1983, in taxable years ending after such date.

(2) BINDING CONTRACTS.—The amendments made by this section shall not apply with respect to any property used by a tax-exempt entity if such use is pursuant to one or more written binding contracts

which on May 23, 1983, and at all times thereafter, required—

(A) the taxpayer (or his predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate such property, and

(B) the tax-exempt entity (or a related entity) to use such property.

In the case of any property used by the United States or an agency or instrumentality thereof, the preceding sentence shall apply only if such property is placed in service by the taxpayer before January 1, 1984.

(3) MASS COMMUTING VEHICLES.—The amendments made by this section shall not apply to any qualified mass commuting vehicle (as defined in section 103(b)(9) of the Internal Revenue Code of 1954) which is financed in whole or in part by obligations the interest on which is excludable from gross income under section 103(a) of such Code if—

(A) such vehicle is placed in service before January 1, 1988, or

(B) such vehicle is placed in service after such date—

(i) pursuant to a binding contract or commitment entered into on or before May 23, 1983, and

(ii) solely because of conditions which, as determined by the Secretary of the Treasury or his delegate, are not within the control of the lessor or lessee.

Chairman Rostenkowski. The committee will come to order.

In recent months, the committee has learned that governments and other tax-exempt entities are engaging in leasing transactions which have threatened to seriously erode the Federal Government's tax receipts.

This is happening at a time of record deficits with no relief in sight, even if the economy recovers. These transactions have included the sale and leaseback of existing buildings such as museums, city halls, and basketball arenas.

In some cases, equipment is being leased, as with the Navy ship leasing program, examined in hearings conducted by our Oversight Subcommittee.

Some cases involve newly constructed or rehabilitated buildings. There even appears to be a substantial volume of leasing to foreign governments and firms where U.S. lessors gain U.S. tax benefits on property used outside the United States.

All of these transactions involve some or all of the following tax benefits: accelerated depreciation, the investment tax credit, rehabilitation credits and tax-exempt financing.

Our hearing today will focus on H.R. 3110, the Government Leasing Tax Act of 1983. This bill was introduced by Mr. Pickle with the cosponsorship of a number of other members of this committee.

The bill would reduce the depreciation allowances for property used by tax-exempt entities and tighten the current rule so that the investment tax credit cannot be claimed with respect to property used by tax-exempt entities. The bill also generally prevents the combined use of taxing in financing and rehabilitation credits.

I would like at this time to recognize my colleague, the chairman at the Subcommittee on Social Security, Jake Pickle, who is the author of the legislation under current consideration.

Mr. Pickle. I thank you, Mr. Chairman, and I want to express my appreciation to you for scheduling these hearings on this bill. We call it the Governmental Leasing Tax Act.

Maybe we ought to call it the Revenue Tax Act of 1983. I am glad to see so many people here in an unselfish, public-spirited manner in these hearings.

I welcome my colleagues here to learn a little bit more about this Alice in Wonderland world of off-budget finance. A looking glass world where grants in aid to cities and schools are slashed while tax expenditures, that is, revenue losses associated with these tax breaks, for the same institutions are up without limit if they rent rather than buy.

A wonderful world where direct appropriations for ships, planes, satellites are denied, while tax expenditures for these same procurements are allowed to pass unchallenged if they are leased rather than purchased.

A curious world where historic structures and college campuses, in desperate need of renovation, repair and operating capital must be sold and leased back to their original owners to be saved.

Now, of course, all of this is not what it seems as we all know. It is just a make-believe world. As the chairman said just a minute ago, we have noted recurring stories from the news about extraordinary new financing mechanisms which are being used by Federal, State, and local government, and other nontaxable agencies to acquire everything from Navy cargo ships, Air Force jets, and entire college campuses.

As higher bond rates have made borrowing more expensive to local governments and as Federal funding for infrastructure needs have been cut back, nontaxable agencies at the Federal, State, and local level have searched for ways to attract private financing of their capital needs. Increasingly, they have turned to this ingenious financing mechanism called leveraged leasing.

What is the carrot, Mr. Chairman, that Federal, State, and local governments and other nontaxable agencies are holding out to induce private investors to underwrite their development projects?

Well, the carrot is tax breaks. I might add, this is no scrawny carrot, either. It is a big carrot. Bugs Bunny never had a bigger carrot in all his life.

Under present law, cities and counties, and States, and Federal agencies can literally dole out tax writeoffs to private developers in the form of accelerated depreciation investment tax credits and interest deductions that the developers would never qualify for on their own account.

Now, Mr. Chairman, this practice is growing enormously and if we don't stop it, we will lose billions of dollars in tax revenue.

I recognize that the effective dates and the transition dates may be controversial to some and it is a matter that we will have to look at closely. But I submit to you that we must remain firm in putting a stop to this kind of a practice and I thank the chairman.

Chairman ROSTENKOWSKI. Mr. Conable is recognized.

Mr. CONABLE. Mr. Chairman, I would like to address a very limited part of this problem and that is the problem of transition dates. I don't think there is anything magic about the date that our colleague, Mr. Pickle, picked out when he put this bill in. But I would like to say to the people in this room obviously concerned about the outcome, many of whom have wonderful projects in mind at this point that you better not assume that we will give way on the transition dates in order to justify the race going to the swift at this point.

We all know that transition dates get changed. We all know that this is a tremendously accelerating trend—this trend of selling and leasing back and looking for this type of tax advantage.

In the past we have frequently recognized the glint in the eye ultimately because it was so difficult to sort out at the appropriate time for the law to take effect.

I just want to say to people that if you assume we are going to move that transition date to some later period and, therefore, you move quickly and institutionalize the glint in the eye now, you will be recognized, you may be making a mistake.

I think everybody understands we have got to do something in this area, and I commend the gentleman from Texas for having moved vigorously to try to change what many of us view to be the potentially serious loss of revenue.

But transition rules, while they are going to remain within the control of the committee and not necessarily within the control of the sponsor of the original bill, had better not be assumed to be the subject of considerable leniency just because some hardship might be caused for those who are only now beginning to conceive some wonderful way to get a major tax writeoff through the leasehold opportunity.

That is all I would like to say, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Dorgan is recognized.

Mr. DORGAN. Thank you, Mr. Chairman.

I am pleased to cosponsor this legislation with Mr. Pickle and other members of the committee. Having worked with the Tax Code for a number of years, I know that there are times when provisions of the Tax Code really become the theater of the absurd and I think that is what has happened in this instance.

When the Tax Code really encourages the selling of city hall or the selling of college campus buildings or the leasing of Navy ships, the combination of which is going to turn out to be more expensive to our governments, then it is time for us to take the reins and suggest that we either got some punctuation marks wrong or some words wrong in the Tax Code and make some dramatic changes.

I think that is what we are trying to do here. I think this particular activity is symptomatic of some real serious problems in our country.

We have buzzing activity on our Tax Codes. It is sort of a paper entrepreneurialism that creates nothing of value in this country, a tremendous amount of activity, but nothing of value. But the fact is this tax loophole that encourages the sale of city hall or campus buildings or renting a Navy is a tax loophole that has the potential of being the Grand Canyon of tax loopholes in this country.

It starts out to be a slow bleed, but will very quickly turn into a massive hemorrhage lest we stem it, and this bill is a good attempt to stem what otherwise will be a massive drain on this Federal Government's treasury for wholly illogical purposes.

I think it is a good approach. I am very anxious to hear the testimony, and I hope we can move quickly and take some decisive action.

Chairman ROSTENKOWSKI. Our first witness is the Assistant Secretary for Tax Policy, the Honorable John Chapoton. Welcome, back. It is nice to have you back.

If you are ready to proceed, the committee is ready to receive your testimony.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. I am pleased to be here today to present our views on H.R. 3110, which would, as has been discussed in certain tax, has been used in other tax-exempt entities. The Treasury Department generally supports the bill as it applies to domestic tax-exempt entities.

In recent months we have become concerned by the mounting evidence of activity in this area. The activity has potential for unanticipated Federal revenue losses of significant size and we believe corrective measures should be enacted along the lines of the bill.

There has been a sharp increase in the volume of leasing between taxable entities as lessors and tax-exempt entities as lessees in the recent months.

Some of the more celebrated transactions include the sale and leaseback of the city hall in Atlanta; the sale and leaseback by Bennington College of its classrooms and dormitories to its alumni; and the sale and leaseback by two municipal buildings in Oakland.

The pace of these transactions is accelerating. They have been the subject of extensive publicity in both financial and general circulation media.

These lease transactions usually involve the sale by a tax-exempt entity of a depreciable asset that it owns, usually a building, to a taxable investor, followed by a long-term lease of the property back to the tax-exempt entity.

As lessee, the tax-exempt entity retains the same use of the property it had before the sale and merely makes rental payments. As the owner of the property, the lessor is entitled to any cost recovery deductions and tax credits associated with the property, and, in some cases, the lessor may be able to finance the acquisition of the property with tax-exempt industrial development bonds. A portion of the tax benefits claimed by the lessor will flow through to the tax-exempt entity in the form of reduced rents.

H.R. 3110 is intended to reduce significantly the tax incentives associated with the property used by a governmental or other tax-exempt lessee. This is accomplished generally by lengthening the period over which the owner of the property used by tax-exempt entities may claim cost recovery deductions. The bill would also eliminate many of the tax benefits of certain property used by foreign persons.

In addition to the changes in the depreciation and in the ITC allowable to the lessor, the bill would also eliminate the special credit for qualified rehabilitation expenditures where either the cost of the building or the related rehabilitation expenditures are financed with tax-exempt IDB's.

Also, the bill would include certain foreign persons within the scope of the term tax-exempt entity and, thus, the bill would reduce significantly the tax incentives with respect to property used by foreign persons where the income from ultimate use of the property is not subject to taxation in the United States.

The Treasury Department generally supports the provisions of 3110 as they apply to properties used by domestic tax-exempt entities. We believe the restriction should be placed on leasing by tax-exempt entities for three basic reasons.

First, it gives them the benefit of tax incentives that were intended to be limited to persons subject to tax. Second, such leasing has the potential for significant arbitrage abuse. Third, if left unchecked, these leasing arrangements could result in billions of dollars of unanticipated Federal revenue loss.

The tax incentives of ACRS and the investment tax credit should be limited to assets that are used by entities subject to tax. If tax-exempt institutions are allowed to lease assets that are entitled to ACRS deductions, then a portion of the tax benefits of ACRS and the investment tax credit will accrue to tax-exempt lessees.

The increased deductions enacted as a part of ERTA were intended to reduce the cost of capital to firms subject to tax. These incentives were introduced to help offset the income tax deterrence to private capital formation. They were not designed to be available directly to tax-exempt organizations, and they should not be available indirectly through leasing.

The second point I raised as the basis of our objection is the potential for arbitrage through leasing arrangements. A lease financing arrangement permits the lease of the property to the tax-exempt user at a cost that is reduced by reason of the tax benefits available to the lessor. The reduction in financing cost is similar to that obtained through tax-exempt financing, though not as beneficial. But the arbitrage rules applicable to tax-exempt financing in general do not apply to funds that are made available through a leasing transaction.

Thus, unlike a direct borrowing transaction, the funds made available to a State or local government through a leasing transaction may be invested in taxable securities paying a higher rate of return than the effective interest rate under lease. This clear potential for arbitrage use should be curbed immediately.

We also agree with the approach of the bill before you because it will hold down the revenue loss that would otherwise occur. By allowing tax-exempt entities the benefit of ACRS, more capital will flow in the tax-exempt sector greatly increasing the potential revenue loss from those tax benefits. We think that the revenue loss could be in the billions of dollars annually.

To eliminate fully any tax advantage for tax-exempt entities to lease, the tax benefits associated with the leased property should be reduced to an extent that the borrowing rate to the tax-exempt entity on lease transaction equals the rate of taxable borrowing.

This may be accomplished by limiting the depreciation to economic depreciation. Such a limitation would remove all potential for arbitrage abuse, but it would go beyond limiting the benefits of ACRS to the private sector because it would treat some of the assets used by a tax-exempt sector more harshly than under pre-ACRS law.

The bill provides for harsher treatment than true economic depreciation in some cases, and more favorable treatment in others. The bill also provides for a harsher treatment than pre-ACRS law in some cases and more favorable in others. We think the committee should apply one criteria consistently. That is either economic depreciation or pre-ACRS rules and we want to work with the committee and its staff to choose the correct criteria.

There are exceptions in the bill to the general rule, and we agree that there are exemptions needed. The bill would exempt short-term and casual leases of personal property from the application of the rules that require a longer spreading of depreciation and denial of the investment credit.

We think the definition of a short-term lease that is excluded from these rules needs some clarification, principally because the interpretation of the existing law is not clear and is not sound.

We recommend that the short-term leases be clarified so as not to cover leases with a term that is less than 1 year or, if greater, less than 30 percent of the property present ADR class.

In the case of real property, the bill would exempt real property leases from the spreading of depreciation if less than 20 percent of the building is used by a tax-exempt entity. We would recommend lowering this threshold from 20 percent to 10 percent of the building's floor space, and we would also recommend having a 10 year short-term leasing exception similar to that discussed in connection with personal property. We believe that the problems for abuse are not significant where there is limited use of the building by a tax-exempt entity.

We also believe the committee should consider restricting the special credit for qualified rehabilitation expenditures for property that is leased to a tax-exempt entity.

Many cities and universities own buildings that are old enough to qualify for the special rehabilitation credit that was enacted as a part of ERTA and this alone could be sufficient incentive in some cases to encourage a tax-exempt entity to enter into a tax-motivated lease transaction.

The bill would limit the availability of the rehabilitation credit only where the building or the qualified expenditures are financed with tax-exempt IDB's. We think it should go further and eliminate the credit for rehabilitation expenditures on nonhistoric structures when the property is leased to a tax-exempt entity whether or not it is financed with tax-exempt bonds.

We do think the role of the rehabilitation credit for historic structures that are leased to tax-exempt entities deserve further study and we want to report back to the committee on that.

With respect to real estate, the provisions of the bill would require the spreading of depreciation only if the real property falls in one of four specific categories. We think the categories specified in the bill are too narrow and the provisions should aply to all property subject to a long-term lease.

The same considerations are present whether or not the property subject to the lease is financed with IDB's, for example, which is one of the criteria in the bill. If the provisions of the bill do not apply to all long-term leases of real property, the selling of tax benefits by tax-exempt entities will continue in the same manner as before, only the form of the transaction will be altered.

Turning to leasing by the Federal Government, H.R. 3110 would apply the same restrictions on leasing of property to Federal Government as to other tax-exempt entities.

We have no objection to this breadth of application of proposed rules, but we do wish to note that the nature of a problem relating to Federal Government leasing is different than the problems presented in the case of leasing by State and local governments and tax-exempt organizations.

Leasing to non-Federal tax-exempt carries with it a significant revenue loss. In contrast, allowance of ACRS and the investment tax credits on assets leased to the Federal Government, per se, has no real budget impact provided the lease is properly accounted for in the budget process.

Treasury is now working with the Office of Management and Budget to develop guidelines for evaluating leases if the Federal Government is the user of the property.

The objective of these guidelines is to provide a procedure that will enable the agency procurement officials and OMB examiners to determine in particular instances whether it is cheaper for the Government to buy or lease a particular item of property and, if it is leased, what the revenue-side budget effect will be.

Obviously these guidelines can be tailored to take into effect whatever changes in the tax treatment of lessors you think appropriate.

The guidelines will be needed whether or not the tax incentives are significant because leasing may afford the Federal Government, as well as other tax-exempt organizations, nontax cost benefits and, therefore, leasing will remain a viable option for tax-exempt organizations and for the Federal Government even after access to the capital formation tax incentives intended for the private sector are no longer available to the lessor.

The question of lease versus a service contract will be presented in much greater relief once a bill along the lines of 3110 is enacted, since any reduction in tax incentives for property that is leased will cause taxpayers to attempt to restructure their transactions as service contracts rather than leases. The bill attempts to deal with this problem to prevent the avoidance of limitations by means of a service contract. We support this effort.

We think the present criteria used by the courts and the IRS in categorizing an agreement as a service contract are far too liberal and should be tightened. In our written statement we suggest some specific tightenings of the bill before the committee in determining whether a particular arrangement is a lease or a service contract.

Turning to the transitional rules, the bill would apply to property placed in service after May 23 unless on that date the taxpayer had a binding contract and the bill makes it clear that the contract had to be binding on the taxpayer to acquire the property and, in addition, on the tax-exempt entity to use the property.

In the case of property leased to the Federal Government, the transitional rule would apply only where the property is placed in service by January 1 of 1984.

We agree that a strict set of transition rules is desirable. However, we do think that the same transitional rules that are included in the bill for property leased to other tax-exempt organizations should be applied to property that is leased to the Federal Government. In any of these lease transactions, money will have been spent by private parties to negotiate and structure the lease transaction. The considerations of equity and fairness that dictate the existence of a binding contract rule with respect to private investors and entities other than the Federal Government would apply to lease transactions involving the Federal Government as well.

Finally, with respect to foreign lessees, as I have indicated, the restrictions that the bill would impose on the leasing of property to the Federal Government and other tax exempts would apply in the case where the lessee is a foreign government or a foreign person whose income from the property is exempt from U.S. tax.

We support this result in the case of leases to foreign governments since the property used in the United States by such lessees should not be more favorably treated for U.S tax purposes than properties used by the Federal Government and other tax-exempt users.

Different considerations, however, apply to foreign non-governmental users, including foreign corporations owned by foreign governments, from those applicable to other types of users that are affected by H.R. 3110.

ACRS was not intended to benefit owners of assets used abroad just as it was not intended to benefit tax-exempt users of property. Congress has already denied ACRS for property used abroad, even if leased from a U.S. owner. Further, foreign users are generally subject to tax in their country of residence and, therefore, the potential arbitrage abuses I discussed earlier are not present.

But there are different economic and trade issues presented by foreign users of property leased from U.S. holders and, therefore, we recommend that the portion of the bill that relates to foreign nongovernmental users should be studied further.

Mr. Chairman, that concludes my remarks. I will be happy to attempt to answer any questions you might have.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Committee: I am pleased to appear before you today to discuss H.R. 3110, the Governmental Leasing Tax Act of 1983, which would deny certain tax incentives for property used by governments and other tax-exempt entities.

The Treasury Department generally supports the bill as it applies to property used by domestic entities and foreign governments. In recent months we have become concerned by the mounting evidence of activity in this area. This activity has a tremendous potential for causing unanticipated Federal revenue losses, and we believe corrective measures should be enacted along the lines suggested by the bill. Since we think the considerations that relate to property used by foreign persons are different from those that relate to property used by domestic tax-exempt entities, we recommend that the portion of the bill as it relates to foreign persons (other than foreign governments) be withdrawn for further study.

BACKGROUND

There has been a sharp increase recently in the volume of leasing between taxable entities, as lessors, and tax-exempt entities, as lessees. Some of the more celebrated transactions include the sale and leaseback of the city hall building in Atlanta; the sale and leaseback by Bennington College of its classrooms and dormitories to its alumni; and the sale and leaseback of two municipal buildings in Oakland. The pace of such transactions is accelerating rapidly, and they have been the subject of extensive publicity in both the financial and general circulation media.

The lease transactions that have received the most publicity involve the sale by a tax-exempt entity of a depreciable asset that it owns (usually a building) to a taxable investor, followed by a long-term lease of the property back to the tax-exempt entity. As lessee, the tax-exempt entity retains the same use of the property it had before the sale and is obligated to make a series of periodic rental payments to the lessor. As the owner of the property, the lessor is entitled to any cost recovery deductions and tax credits associated with the property, and, in some cases, the lessor may be able to finance its acquisition of the property with tax-exempt industrial development bonds ("IDBs"). A portion of the tax benefits claimed by the lessor flow through to the tax-exempt entity in the form of reduced rents. In effect, the tax-exempt entity is able to acquire private investment funds at a tax-preferred rate of return. In addition, if the tax-exempt entity invest the sales proceeds in taxable assets, it receives a tax-exempt return on that investment. Of course, leasing may be used by a tax-exempt entity to finance the construction or acquisition of new real or personal property, as well as in sale-leaseback transactions involving existing properties.

Whether an agreement that, in form, is a lease is considered for tax purposes to be a lease, a conditional sale, or other financing agreement is a question of fact to be determined from all the surrounding circumstances. The tax status of such an agreement is important because ownership of the property for tax purposes determines the party entitled to claim the cost recovery deductions and investment credits (if any) associated with the property.

Cost recovery deductions.—If an agreement is treated as a lease for tax purposes, the lessor is considered the owner of the property. As such, the lessor is required to include in its taxable income any rental income received and is also generally entitled to recover its cost of the property through depreciation deductions under the Accelerated Cost Recovery System (ACRS) enacted in the Economic Recovery Tax Act of 1981 (ERTA). Under ACRS, cost recovery deductions are taken over 3 or 5 years for most personal property and over 10 or 15 years for public utility property and depreciable real property. The ACRS rules generally apply only to property that is acquired after 1980. If the property was owned either by the lessor or the lessee prior to 1981, the lessor's depreciation deductions are limited to those allowable under the law in effect prior to ERTA. In that case, the deductions to the lessor must be spread over the useful life of the property, and the method of depreciation (i.e., straight line or accelerated) will vary depending upon the nature of the property and whether the original use of the property commenced with the lessor. Under the law prior to ERTA, the lessor's depreciation deductions for buildings and other depreciable real property generally must be computed using the straight-line method if the lessor is not the original user of the property.

In general, whether a lessee is a taxable or a tax-exempt entity is irrelevant in determining the timing and amount of cost recovery deductions entitled to be claimed by a lessor. However, special rules apply to limit a lessor's depreciation deductions where the property subject to the lease is used predominantly outside the United States.

Investment tax credit.—Conversely, the tax status of a lessee is important in determining the eligibility of property for purposes of the investment credit rules. Currently, the lessor of property that qualifies for regular investment credit is entitled to a tax credit equal to 10 percent (6 percent in the case of short-lived property) of his investment.

Real property is not eligible for an investment credit generally, but a special tax credit is allowed for certain "qualified rehabilitation expenditures." The tax credit for qualified rehabilitation expenditures (which are generally capital expenditures incurred in the rehabilitation of an existing structure) varies from 15 percent to 25 percent of the total expenditures depending on the age of the rehabilitated structure and whether the structure qualifies as a "certified historic structure." The special credit for qualified rehabilitation expenditures is available for buildings leased to a tax-exempt entity to the extent of such expenditures.

In general, property used by an organization that is exempt from tax, including the United States, any State or political subdivision thereof, and any governmental agency, does not qualify for an investment credit. In determining whether property is considered "used" by a tax-exempt entity and is thus not eligible for the regular investment credit, the Treasury regulations state that property is used by a tax-exempt entity if the property is owned by or leased to a tax-exempt entity. The restriction placed on property leased to a tax-exempt entity does not, by regulation, apply to short-term or casual leases. These have been generally interpreted by the courts to mean leases of less than one year's duration.

Service contracts.—While the investment credit is generally not available for property leased to a tax-exempt entity, the investment credit limitation does not apply to property that is used by the owner in providing services for a tax-exempt entity under a service contract or agreement. Whether an agreement is a service contract or a lease is an inherently factual determination. There are a handful of cases and IRS rulings that discuss the issue. Under a lease agreement the lessor generally transfers possession and control of the property to the lessee for a stated term, and the lessee is responsible for the day-to-day operation of the property. In contrast, under a valid service agreement, the party who receives the services from the property may be able to direct when and where the property is to be used; but control, possession, and day-to-day operation of the property remain with the supplier of the services.

Tax-exempt financing.—In addition to the investment credits and ACRS deductions associated with the leased property, tax-exempt financing plays a major role in these transactions. Section 103(a) of the Code generally exempts from Federal taxation interest paid on obligations of a State or local government. Section 103(b) of the Code restricts the tax exemption for IDBs to obligations whose proceeds are used for certain specified purposes. Code section 103(c) denies tax-exempt treatment for any State or local government obligation that is an "arbitrage bond" (i.e., an obligation the proceeds of which (i) are invested in taxable securities that are expected to produce a yield that is materially higher than the yield on the obligation, or (ii) are used to replace funds that are invested in such taxable securities).

H.R. 3110, THE GOVERNMENTAL LEASING TAX ACT OF 1983

In general, H.R. 3110 is intended to reduce significantly the tax incentives associated with property that is used by governmental and other entities that are exempt from Federal incomes taxes. This is accomplished generally by lengthening the period over which the owner of property used by a tax-exempt entity may claim cost recovery deductions with respect to the property and by tightening the criteria that are used in distinguishing a lease from a service agreement. The bill would also eliminate many of the tax benefits on certain property used by foreign persons.

Specifically, H.R. 3110 would provide that, except in the case of a casual or short-term lease, the cost recovery deductions for personal property used by a tax-exempt entity must be computed using the straight-line method over 5 years for property in the 3-year ACRS class, 12 years for property in the 5-year ACRS class, 25 years for property in the 10-year ACRS class, and 35 years for property in the 15-year public utility property ACRS class. In the case of property in the 15-year real property ACRS class, the cost recovery period would be extended to 35 years, but only where more than 20 percent of the property is used by the tax-exempt entity and either: (i) the property was financed in whole or in part with tax-exempt obligations in which the tax-exempt entity participated in the financing; (ii) the tax-exempt lessee has an option to acquire the property for a fixed price or the lessor has the right to sell the property to the tax-exempt lessee for a fixed price; (iii) the tax-exempt entity protects the lessor from loss on his investment; or (iv) the tax-exempt entity sold (or leased) the property and then leased it back. Property that is not recovery property under the ACRS rules would be treated as recovery property for purposes of these restrictions.

Further, the bill would eliminate the special credit for qualified rehabilitation expenditures where either the cost of the building or the related rehabilitation expenditures are financed with tax-exempt IDBs.

In addition to Federal, State and local governmental units and other tax-exempt organizations, the bill would include certain foreign persons within the scope of the term "tax-exempt entity." Thus, the bill would significantly reduce the tax incentives with respect to property used by a foreign person where the income from the ultimate use of the property is not subject to United States taxation. In such a case, the cost recovery deductions with respect to such property would be limited in the same manner as described above in connection with other tax-exempt entities. The bill would also deny an investment credit on such property.

The bill appears to place further limits on the types of agreements that will qualify under current law as service contracts. Under the bill, a contract that purports to be a service contract is treated as a lease if the contract is more properly treated as a lease, taking into consideration such factors as whether the tax-exempt entity controls the property and has a significant possessory or economic interest in the property.

The provisions of the bill generally would apply to property placed in service after May 23, 1983, except that the bill would not apply to property placed in service after that date if, pursuant to one or more written binding contracts in existence on May 23, 1983, (i) the taxpayer is under an obligation to acquire, construct, or rehabilitate the property, and (ii) the tax-exempt entity is obligated to use such property. This special transitional rule for property subject to a binding contract on May 23, 1983, would apply to property used by the United States only if such property is placed in service before January 1, 1984.

Finally, the amendments made by the bill would not apply to "mass commuting vehicles" (as defined in section 103(b)(9) of the Code) (i) if the vehicle is placed in service before January 1, 1988, or (ii) if placed in service after that date, the vehicle generally was acquired pursuant to a binding contract or commitment entered into on or before May 23, 1983.

DISCUSSION

The Treasury Department generally supports the provisions of H.R. 3110 as they apply to property used by domestic tax-exempt entities. We believe that restrictions should be imposed on leasing by tax-exempt entities for three basic reasons: (i) it gives tax-exempt entities the benefit of tax incentives that were intended to be limited to persons subject to tax, (ii) it has potential for significant arbitrage abuse, and (iii) if left unchecked, it could result in billions of dollars of unanticipated Federal revenue loss.

Scope of ACRS

The tax incentives of ACRS and the investment tax credit should be limited to assets that are used by entities that are subject to tax. If tax-exempt institutions are allowed to lease assets that are entitled to ACRS deductions or that qualify for the investment credit, then a portion of the tax benefits of ACRS and the investment credit will effectively accrue to tax-exempt entities. The increased deductions and credits enacted as part of ERTA were intended to reduce the cost of capital to firms subject to tax. They were introduced to help offset the income tax deterrence to private capital formation. These tax benefits were not designed to be available directly to tax-exempt organizations, and they should not be available indirectly through leasing.

Arbitrage concerns

The second reason we support further restrictions on leasing by tax-exempt entities is that it has a tremendous potential for abuse through arbitrage.

Lease financing by a tax-exempt entity permits it to obtain the use of property at a cost that is reduced by reason of the tax benefits available to the lessor. The reduction in financing cost is similar to that obtained through tax-exempt bond financing. However, a major difference between the two forms of financing is that the arbitrage rules of the Code, which generally prevent a State or local government from taking the proceeds of a tax-exempt bond issue and investing them in taxable securities at a higher interest rate, do not apply to funds that are made available through a leasing transaction. Thus, unlike a direct borrowing transaction, funds made available to a State or local government through a leasing transaction may be invested in taxable securities paying a higher rate of interest than the effective interest rate under the lease.

This clear potential for arbitrage abuse should be curbed immediately. Moreover, the solution to the problem should be designed along the lines of the approach taken in H.R. 3110, namely, to reduce the tax incentives associated with property that is leased to a State or local government. Merely extending the present arbitrage rules to proceeds obtained from a leasing transaction would not provide a satisfactory solution. Except in the most obvious cases, the arbitrage rules relating to tax-exempt bond issues do not work well. The fungibility of money makes the rules difficult to administer and subject to a great deal of contention between governmental units and the Internal Revenue Service. Moreover, the potential for arbitrage abuse exists even if the proceeds of the lease transaction are directly traceable to the construction of a capital asset such as a school, road, sewer system, etc. The use of the money in this fashion merely frees up other funds that may be used to invest in taxable securities.

Revenue loss considerations

We also agree with the approach used in H.R. 3110 to reduce the tax benefits on property that is leased to a tax-exempt entity because it will hold down the revenue loss that would otherwise occur. By allowing tax-exempt entities to realize the benefits of ACRS and the investment credit, more capital will flow into the tax-exempt sector, and thus greatly increase the revenue loss. If the current trend continues, this unanticipated revenue loss could be as high as billions of dollars annually.

Proposed limitations

To eliminate fully any tax advantage for tax-exempt entities to lease, the tax benefits associated with leased property should be reduced to such an extent that the borrowing rate to the tax-exempt entity on the lease transaction equals the rate on taxable borrowings. This may be accomplished by limiting a lessor's depreciation to a rate no faster then the economic rate of depreciation. Such treatment removes all potential for arbitrage abuse, but goes beyond limiting the benefits of ACRS to the private sector because it would treat some assets used in the tax-exempt sector more harshly than under pre-ACRS law.

The bill provides for harsher treatment than true depreciation in some cases and more favorable treatment in others. Further, the bill also provides for harsher treatment then pre-ACRS law in some cases and more favorable in others. We believe the Committee should apply one criterion consistently, economic depreciation or prior law. We would like to work with the committee in choosing the correct criterion, and the rules that would be used to apply it.

Exceptions to the General Rules

Personal property.—We agree with the provision of the bill that would exempt short-term and casual leases of personal property from application of the rules that require a spreading of the depreciation and denial of the investment credit. However, we would prefer to define a short-term lease more broadly than it is now construed in connection with the present investment credit rules under Code sections 48(a)(4) and (a)(5). Under the present interpretation of these provisions the categorization of a lease as short-term is determined without regard to the length of the lease term relative to the economic life of the property. This interpretation would deny the investment credit in a case, for example, where property with an economic life of 10 years is leased for only 1 year. We do not think that case presents the same potential for abuse as a long-term lease. We therefore recommend that the short-term lease exception be clarified so as not to include leases with terms that are less than 1 year or 30 percent of the property's present class life, whichever is greater.

Real property.—The bill would exempt real property from the spreading of depreciation unless more than 20 percent of the building is used by a tax-exempt entity. While not clear, it would appear that the 20-percent test refers to the building's floor space and not to its useful life. Thus, for example, the new rules would apply to a situation where a tax-exempt entity rents an entire building with a 50-year economic life for only 1 year, but would not apply where 20 percent of the same building were occupied by a tax-exempt entity for 50 years. We think de minimis thresholds should apply to both horizontal and vertical slices of the property. In this regard, we recommend lowering the threshold from 20 percent to 10 percent of the building's floor space and having a 10-year short-term lease exception similar to that discussed in connection with the exception for short-term leases of personal property. Thus, we believe the special depreciation rules should not apply for any year unless more than 10 percent of the building is occupied by a tax-exempt entity, and the lease term extends for more than 10 years. Leasing by a tax-exempt entity that comes within this exception does not present the same potential for abuse as a long-term lease.

Other proposed limitations

We also believe that the Committee should consider restricting the special credit for qualified rehabilitation expenditures on property that is leased to a tax-exempt entity. Many cities and universities own buildings that are old enough to qualify easily for this special rehabilitation credit. This incentive by itself may be sufficiently large in some cases to encourage a tax-exempt entity to enter into a tax-motivated lease transaction. The bill would eliminate this special credit only where the building or the qualified expenditures are financed with tax-exempt IDBs. We think the bill should go further and eliminate the credit for rehabilitation expenditures on non-historic structures when the property is leased to a tax-exempt entity. The role of the rehabilitation credit for historic structures leased to tax-exempt entities deserves further study.

The provisions of the bill that require a longer depreciable life for real property apply only to 4 categories of real property, i.e., (1) property that is financed in whole or in part with tax-exempt obligations; (ii) property subject to a lease under which the lessee has an option to acquire the property for a fixed price or the lessor has a right to sell the property to the tax-exempt lessee; (iii) property on which the tax-exempt entity protects the lessor from risk of loss; and (iv) property sold by the tax-exempt entity to the lessor and leased back. We think these categories are too narrow and that the provisions of the bill should apply to all real property subject to a long-term lease. The same considerations are present whether or not the property subject to the lease is financed with IDBs, for example. If the provisions of the bill do not apply to all long-term leases of real property, the selling of tax benefits by tax-exempt entities will continue in the same manner as before and only the form of the transactions will be altered.

LEASING BY THE FEDERAL GOVERNMENT

The restrictions on leasing of property to governments and other tax-exempt organizations proposed by H.R. 3110 would apply when the Federal government is the lessee. We have no objection to this breadth of application of the proposed tax rules, but think that economic depreciation (not pre-ACRS law) should be the standard rule for assets leased to the Federal government. Further, we wish to note that the nature of the problems relating to Federal government leasing is different than those presented in the case of leasing by State and local governments and tax-exempt organizations.

Leasing by State and local governments or tax-exempt organizations provides these entities access to Federal tax incentives that were intended to encourage capital formation in the private taxable sector. This access makes it possible for these tax-exempt entities to engage in the arbitrage activities and tax-preferred lease financings described above; activities intended to be proscribed by the Congress. Leasing to non-Federal tax-exempt organizations, therefore, carries with it significant revenue losses.

In contrast, allowance of ACRS and the investment credit on assets leased to the Federal government, *per se*, has no real budget impact, provided the lease is properly accounted for in the budget process. If Congress authorizes the purchase of property by a Federal agency, the full cost of that service is reflected in the outlay side of the budget. Assuming that Congress approves of the purpose served by that same property when it is leased from a private firm, then the cost will be borne on both sides of the budget: on the outlay side to the extent of lease rentals paid lessors; on the revenue side to the extent that tax incentives are used by lessors. The "problem" of Federal government leasing, therefore, is not its effect on the budget, but rather is to ensure that full accounting for costs takes place and that the choice between government purchase and leasing is based on the lower cost alternative.

The effect of restricting the terms of Federal government leases to economic depreciation and denying of the investment tax credit in service contracts therefore will have no real effect on the deficit. Rather, the resulting higher rentals will have the salutary effect of more accurately displaying the cost of government leases of equipment and buildings than is presently the case.

Treasury is now working with the Office of Management and Budget to develop guidelines for evaluating leases if the Federal government is the user of the property. The objective of these guidelines is to provide a procedure that will enable agency procurement officials and OMB examiners to determine, in particular instances, whether it is cheaper for the government to buy or lease a particular item of property, and, if it is leased, what the revenue-side budget effect will be. Obviously, these guidelines can be tailored to include such changes in the tax treatment of lessors as the Congress deems wise. The guidelines will be needed whether or not private sector tax incentives are consequential, for leasing may afford the Federal government (and other tax-exempt organizations) non-tax cost-reducing options that should be examined. Leasing was a viable option for tax-exempt organizations before the era of capital formation tax incentives; it will remain one after access to these private (taxable) sector incentives are denied lessors to tax-exempt organizations.

Lease vs. Service Contract

Any reduction in tax incentives for property that is used by a tax-exempt entity will place a great deal of renewed emphasis on the distinction between leases and service contracts. In this respect, the bill would attempt to prevent the avoidance of the limitations on cost recovery deductions and investment credits by means of a service contract. We support this effort. The present criteria used by the courts and the IRS in categorizing an agreement as a service contract are too liberal and should be tightened.

While it is not clear from the bill how an agreement should be analyzed, this is probably due in large part to the fact that it is difficult to draft statutory rules to cover situations that are inherently factual determinations. Presumably, the draftsmen expected many of the details to be fleshed out in the Committee Reports and regulations.

In our opinion, the answer to whether property should be subject to the provisions of the bill should not depend on whether something is a lease or a service agreement per se. The test or factors to be applied to determine when the limitations of the bill should apply cannot be readily established and further study of this problem is needed. However, we believe the focus should be on the ultimate use of the property. For example, if property is leased to a tax-exempt entity in the traditional sense, the tax incentives with respect to the property should be reduced. Similarly, whether or not the property is leased to the tax-exempt entity, the credits and deductions probably should not be available for property that is within the physical possession or day-to-day control of the tax-exempt entity. Even if the tax-exempt organization does not have physical possession or day-to-day control of the property, it may be appropriate to deny tax benefits with respect to the property if the service provider bears no substantial risk of loss from nonperformance in using the property or if the service provider is not concurrently using the property to provide services to taxable entities.

Transitional rules

In general, the provisions of the bill would apply to property placed in service after May 23, 1983, unless on that date the taxpayer was under a binding contract to acquire the property, and the tax-exempt entity was under a binding contract to use such property. In the case of property leased to the Federal government, the transitional rule would apply only if the property is placed in service by January 1, 1984.

We would agree that a strict set of transition rules is desirable, particularly since the participants in the lease transactions are taking advantage of an unintended benefit. However, we also believe that the same transitional rules that are included in the bill for property leased to other tax-exempt organizations should be applied to property that is leased to the Federal government. As in the case of a lease to another tax-exempt entity, thousands of dollars may have been spent by private parties to negotiate and structure a lease transaction with the Federal government. Considerations of equity and fairness that apply to transactions involving private investors and entities other than the Federal government apply to lease transactions involving the Federal government as well.

Foreign lessees

As indicated above, the restrictions on leasing of property to governments and tax-exempt entities proposed by H.R. 3110 also would apply where the lessee is a foreign government or where the lessee is a foreign person whose income from the leased property is exempt from U.S. tax. We support this result in the case of leases to foreign governments and international organizations, since property used by such lessees in the United States should not be more favorably treated for U.S. tax purposes than property used by the Federal government and other tax-exempt users.

Under present law, the investment tax credit and the ACRS deductions generally are available where a U.S. person leases property to a foreign person only if the property is used predominantly in the United States. Exceptions to the predominant U.S. use requirement are provided, however, for limited classes of equipment used in international transportation and in international communications.

In the absence of an applicable treaty, the foreign user of such property will generally be subject to U.S. tax on the portion of its income from the use of the property that is attributable to a U.S. business or has a U.S. source. If there is an income tax treaty between the United States and the foreign person's country of residence, U.S. taxation on such income may be eliminated in return for a reciprocal exemption for U.S. residents in the treaty partner's country. The principal effect of H.R. 3110 would be to deny the investment tax credit and to provide less rapid depreciation for property that is used in international transportation or in international communications, even though the property presently qualifies under one of the exceptions to the predominant U.S. use requirement of present law and is exempted from U.S. tax by treaty. Thus, the effect of H.R. 3110 in the case of foreign users would be harsher if the user is from a country with which we have a tax treaty than if he is from a country with which we have no treaty, an anomalous result.

We believe that different considerations apply to foreign nongovernmental users (including foreign corporations owned by foreign governments) from those applicable to the other types of users that would be affected by H.R. 3110. ACRS was not intended to benefit owners of assets used abroad just as it was not intended to benefit tax-exempt users of property. Congress has already denied ACRS for property used abroad even if leased from a U.S. owner. Further, since foreign users are generally subject to tax in their country of residence, the potential arbitrage abuses discussed above are not present.

Accordingly, in view of the different economic and trade issues presented by foreign users, we recommend that the portion of the bill that relates to foreign nongovernmental users (including foreign government-owned corporations that use the leased property in a business) should be withdrawn for further study.

This concludes my remarks. Let me say that we would be pleased to work with the Committee on this bill. I would be happy to respond to any questions that you may have at this time.

Chairman ROSTENKOWSKI. Thank you, Mr. Chapoton.

Mr. Pickle will inquire.

Mr. PICKLE. Thank you for your testimony, Mr. Secretary, and for your support of this bill. I noticed in several places you said unless we stop this practice of sale-leaseback or whatever approach is made, that it would cost the Federal Government billions of dollars annually.

I don't have any figure from you. What kind of an estimate would you make? When you say "billions," in plural, annually, you could mean $1 billion or $25 billion a year.

Can you give us some estimate of the potential size of this problem?

Mr. CHAPOTON. Mr. Pickle, I cannot give you any kind of estimate at the moment with any specificity. We can work on that further.

Obviously, the capital stock of assets used by tax exempts and State and local governments is tremendous and so one can just speculate how much of this leasing would take place and it would be very difficult to put the upside limit on the revenue loss that could occur, but obviously it could be very significant.

Mr. PICKLE. I think the public is entitled to know how big this is. I can see why it would be difficult because when you have got literally tens of thousands of local city and county governments, nontaxable entities over the country, and if all of them participate in this procedure as they are apt to do because it is an enticing thing, then the loss to the Federal treasury has got to be enormous.

I would think we ought to try to give some sort of estimate. I have asked the Joint Tax Committee and they have said it is so big we can't even estimate it.

Now, that is frightening. It is kind of interesting, but it is frightening.

I think that we ought to understand first when we talk about something that can just literally soon cause our Federal Government deficit itself to be doubled, if that is the case, so I hope you can give us some kind of estimate.

Mr. CHAPOTON. Let us work on that. I think we can at least show you the parameters of the potential problem.

Mr. PICKLE. Theoretically, if an entity can get the ACRS and if it can get the ITC or rehab credits and interest deductions, they could get approximately 40 percent of the whole project written off.

If that is the case, in the fullest example, then a billion dollar project could mean the Federal Government would have a revenue loss of $300 or $400 million. It is potentially that big.

I hope you would try to give us some idea of an actual cost figure, if you can.

Mr. CHAPOTON. We would be happy to.

Mr. PICKLE. Now, you also said, with respect to transition rules, that the bill we have introduced provided harsher treatment than true depreciation in some cases than in others, that is between nontaxable and taxable entities, and that observation is valid.

I think we have to recognize we have made a differentiation on it.

When you said that we would like to work with the committee choosing the criteria and the rules that would apply, do you have any recommendation?

What kind of criteria?

Mr. CHAPOTON. Well, I think mechanically we could come up with rules. I think, No. 1, we ought to have hard and fast rules.

We should not have a rule that says if the lessee is a tax-exempt entity, the depreciation is taken over the economic useful life of the property, because then we are back in the world where nobody really knows with precision what the economic life is and we have uncertainty.

We ought to have hard and fast rules. We can approximate with hard and fast rules economic depreciation or we can approximate ADR rules, that is pre-ACRS law.

I think the judgment the committee has to make, and we will be happy to assist you in that, we have not in our own minds decided which is correct, No. 1, whether the depreciation schedule for property leased to a tax-exempt entity should be economic or pre-ACRS.

Mr. PICKLE. One last question. You said that with respect to the foreign entities, that we ought not give foreign investors the availability of using ITC and ACRS if we don't give it to our Government.

We ought not extend it to them and I think that is as sound as can be.

Now, you said however, if we are too strict on them, it might hurt our foreign sales and our foreign export/imports.

You said you don't want to see a foreign government get more out of ACRS than our own Government. You said it could affect our balance of trade in some ways and you think we ought to study it further.

What do you mean by that?

Mr. CHAPOTON. I am not talking about foreign governments. I am simply talking about foreign taxable users of property. Where the user is a foreign government, we would support the bill. Where a foreign taxable user is involved the leased property is not eligible for the full ACRs benefits under current law and the foreign person's return on the asset is already taxable, so the same considerations don't apply.

We think we had better look at that a little more closely and particularly see how it interacts with our tax treaties.

Mr. PICKLE. I thank the chairman.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. CONABLE. Mr. Chairman, I would just like to follow up on the first question Mr. Pickle asked. You say it is difficult to estimate the possible potential revenue loss.

In fact, there has been some leasing that has gone on for a long time involving Government properties. Such things as post offices, for instance, are built by private lessors and the Government enters into long-term leases on buildings.

Would Mr. Pickle's bill have the effect of picking up revenue?

Mr. CHAPOTON. That is a very valid point. If the bill required the depreciation to be more stringent than pre-ACRS rules, it could indeed pick up some revenue.

Let me add, Mr. Conable, that the revenue loss with respect to Federal Government leases of property is really not a revenue loss problem except to the extent the transaction is an inefficient transaction. That is, except to the extent the Government as a lessee does not negotiate a hard deal. It is more of a budgeting problem there. The revenue loss is on the non-Federal Government lessee side.

Mr. CONABLE. But there are, of course, cities up there that have long engaged in leasehold arrangements of one sort or another; I just hope we will have adequate information on which to judge what is an appropriate area of leasing activity and what is not.

To the extent that there is an explosion of leasing going on out there because of all the furtive minds that have suddenly seen this as an opportunity to get substantial revenue enrichment for the actual construction costs, we ought to know about that. I hope there will be some kind of adequate statistical base here for us to know what is appropriate and what is not.

That is a concern of mine because, quite obviously, if we change the practice in significant ways to the extent it will be longstanding and not tax related, we may be going beyond what is required.

Mr. CHAPOTON. That is correct. The bill does contain, and we recommend broadening to some extent, an exception for short-term uses of property.

Mr. CONABLE. There could be very serious definitional problems, though. If a police van were to pick up a suspect in a distant city and rent a Hertz car in order to do his transportation from a different city, that is quite a different situation than if you were to lease a whole fleet of squad cars for the life of the cars. That kind of definitional work is going to have to be done.

Mr. CHAPOTON. That is correct.

Mr. CONABLE. Thank you.

Chairman ROSTENKOWSKI. Mr. Shannon will inquire.

Mr. SHANNON. No questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. No questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Russo will inquire.

Mr. RUSSO. No questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Secretary, I am a cosponsor of this bill, but I have one question that concerns me. It relates to the Navy, that has entered into binding contracts for ships, apparently lawfully and legally, that are due to come off the line in the next few months.

How would you propose to treat that?

Mr. CHAPOTON. The proposal, if it were applicable, would simply require the depreciation to be taken over a longer period of time; that is, reduce the tax benefits to the lessor of those vessels, with the result that the rentals would have to be adjusted upward to the Navy, because the costs to the lessor would be more.

Mr. DUNCAN. But it would cost the Navy more?

Mr. CHAPOTON. It would cost the Navy more on the Navy's lease rentals. It would cost the Federal Government less on the revenue side. Provided the negotiations are hard enough—and there is no reason to think they would not be—so that the transaction is efficient; that is, the benefits are passed through directly in the lease transaction, the Federal Government would not be a net loser if you look at both sides of the transaction.

Mr. DUNCAN. Mr. Conable raises a question about the leasing of office buildings, and so forth. Would you treat them the same way?

Mr. CHAPOTON. That is correct. We treat them the same way.

Mr. PICKLE. Would the gentleman yield?

Let me ask the Secretary about the Navy project.

I would submit to you that the Navy case is probably different from the other transition rules in that the Navy has indemnified the lessor in this particular case. In other words, if the lessor, in putting this project together, does not get their money, then the Navy says they guaranteed it. So it seems to me like the Federal Government is going to pay for this deal either through this leasing business or directly from the Treasury, because the Navy guaranteed.

They don't want to take it out of their O&M project, but they want you to pay for it.

Now, do you have any concern about whose pocket it is coming out of? It seems like the Navy made a deal and you are going to end up holding the sack, no matter what.

Mr. CHAPOTON. The point is that both sides should enter into the proper budgeting of the cost of those vessels. There is no doubt about it.

Mr. PICKLE. Thank you.

Mr. DORGAN [presiding]. Mr. Chapoton, let me follow up on the questions that Mr. Pickle has asked with respect to the hearing that we held on the purchase that the Navy wants to make on the ships.

The Joint Taxation Committee testified that the arrangement that is proposed would end up costing the taxpayers of this country about $200 million in additional money for the use of those ships than if they were to be purchased.

As I understand your testimony this morning, your suggestion under the transitional rules would probably allow that lease by the Navy to be completed.

Mr. CHAPOTON. Sir, I have not reexamined the Navy transaction. We have simply supported the transitional rules included in the bill with one exception. That is, we think the cutoff date for property placed in service by the Federal Government should not be more stringent than that of other tax-exempt leases.

Now, whether the Navy transaction is outside of that, I am not certain. I believe it is, but I have not revisited it in connection with this testimony.

Mr. DORGAN. There is a case in which you have two areas of the Federal Government seeming to operate independently. Do you feel, given the opportunity, that you might support putting a stop to the potential lease of these ships in light of the information we have from the Joint Tax Committee and others, that it will cost an extra $200 million?

Mr. CHAPOTON. I just cannot answer that question without knowing a lot more about the specific facts of the transaction. We do support the bill which would stretch out the depreciable life of the asset which will have the effect of placing the full cost of the lease transaction on the lessee's budget.

Mr. DORGAN. I understand the delicacy with which you answered the question. Our difficulty is that the Government has a rather significant deficit problem, not just this year but in the projected outyears. And here we have a rather substantial lease arrangement that is in the process of being negotiated and consummated.

And the essential facts are not in dispute. And that is that it will end up costing the Government substantially more money.

The question is: Should we put a stop to that even though it is in progress, because we do have the opportunity to stop it? I think the committee would be very interested in your views.

Mr. **Chapoton**. We did in the earlier time. I am not sure that we agreed with the joint committee's conclusion in that regard.

There are two elements that could cost the Federal Government more money. One is the inefficiency of the leasing transaction itself. That is, to the extent the tax benefits don't flow through to the lessee, that they remain in the hands of the lessor.

The second element that will have a cost is the question of financing by the Federal Government. Since the financing is not carried out directly by the issuance of Government bonds, the financing will be a more expensive way for the Government to finance.

Mr. **Dorgan**. Well, aside from the specific question about the Navy proposal, I appreciate your testimony and am pleased that you share the concern of the members of the committee on the potential drain on the Federal Treasury of this incredible leasing arrangement and the drain that that will cause on the Treasury.

I don't think anybody intended that to be the case. It is one of these things that becomes an unintended result of a series of tax laws operating together.

I appreciate your testimony. I think it concurs with the thoughts of many of us in the committee.

Mr. Guarini?

Mr. **Guarini**. I also want to thank you for the direction which you have given this committee and to the sponsor of the bill. There are many changes, of course, that do have to be made, and we are concerned about the serious losses of revenue.

Yet, at the same time, there could be some areas that should be safeguarded particularly where it means more housing and more jobs, because there is always a retro-feedback by establishing more productivity and it could help a sounder overall economy.

The question is, What do you do with that fine line? I notice the bill excludes mass transit vehicles. Is that correct? Because we want to encourage that kind of transportation industry.

How do you feel about other types of projects of which there are many good ones. I am not talking about selling the Brooklyn Bridge but I am talking about boys clubs and YMCA's. They are in old, deserted buildings that could be rehabilitated in targeted areas under certain restrictions and criteria that would eliminate the abuses. Do you feel that a pass-along under those circumstances would be beneficial to our society?

Mr. **Chapoton**. Well, I think once we start down that road, Mr. Guarini, we are going to have a very difficult time drawing the line. The mass transit exception was a clear exception drawn in the 1981 act and, therefore, it seems to me should not be a surprise to us now. But when you start saying what are good projects and what are not good projects, I think you have a difficult time drawing the line. Indeed, most, if not all, of the projects we are talking about will benefit activities that we would all think are very good activities. Bennington College would certainly be a good example of that.

Mr. GUARINI. Would you agree that there could be certain circumstances that could help a community, that a building could be turned into an asset if we had criteria that were sufficiently restricted so that there would be no abuse? Would you support trying to fashion something under targeted areas, high unemployment areas, inner cities that might be able to turn an old coal bunker that has been sitting there for 50 years into a boys club; otherwise, there is nothing that can be done with the coal bunker?

Are there certain circumstances that we could have criteria that might be acceptable to the Treasury?

Mr. CHAPOTON. Well, I am not sure I could agree with that, because the result is going to be in any case a grant to the user, a Federal grant to the user that you decide is an activity you want to encourage. And I am sure all of us will hear about such activities.

I think the word "abuse," you have to use carefully. It is not an abuse if you think the activity using the money is a good activity. But it is an incentive in the tax system that was not consciously considered. That is, we designed a tax program to reduce the tax disincentive to investment, and now it is being used as a grantmaking mechanism to tax-exempt users.

Mr. GUARINI. We do want to safeguard the tax policy and the integrity of the tax code. But, at the same time, of course, we are a nation of people. I was just trying to get across to you the fact that so long as we put safeguards there, that we could help residential properties in inner cities and in targeted areas and make some good use with a little bit of flexibility instead of being totally rigid.

I really commend that to you for your consideration because you said that there are things that are left open concerning foreign and governmental users and support circumstances and service contracts which you have to think out. I would not think you would have to think out too much about putting criteria in place to create a better place for boys to be able to live in inner cities.

Mr. CHAPOTON. The criteria would be that we would decide to make a grant to that activity, and defining the good activity would be the difficult part.

Mr. GUARINI. If it can be done, though, you would consider it?

Mr. CHAPOTON. We would consider it, but I would suggest that that is a very dangerous road to start. It will have revenue consequences. To the extent you decide it is good, the revenue consequences will be exactly the same as a grant-making program.

Mr. GUARINI. Well, these are usually smaller projects of $1 million and $2 million that do an awful lot of good in a community and do put people to work. The fact that these projects use building materials and create jobs has a retro-feedback to the Treasury. The more people we put to work and the more facilities we make available, the better are our tax collectables, so that while you lose at one point you always pick up at the other end.

Thank you.

Mr. DORGAN. Mr. Pease?

Mr. PEASE. Thank you, Mr. Chairman.

If I might just comment on the discussion that preceded this one, I guess I would come down on the side of making things as simple as possible. And I worry about exceptions that are made, also.

Every member of the committee would have an amendment to make an exception for something or another, so I hope the Treasury Department holds firm.

Mr. Chapoton, to what extent is our current problem being addressed by this bill right now the result of ERTA, the 1981 Tax Act?

Mr. CHAPOTON. I am not sure I can answer that with precision, but clearly the availability of the much faster depreciation provisions allowed, the ACRS deduction and also the rehabilitation credit allowed in ERTA, gave impetus to what we are now seeing.

As the point has been made earlier, there was leasing before ERTA by tax-exempt entities.

Mr. PEASE. In your testimony, you note:

> Under ACRS rules, if the property was owned either by the lessor or the lessee prior to 1981, the lessor's depreciation deductions are limited to those allowable under the law and, in fact, prior to ERTA.

Tell me about the Bennington College situation or the city hall situation in Atlanta that you mentioned. Obviously, those were owned prior to 1980 by the lessee, by the city or the college. Why was this arrangement attractive then?

Mr. CHAPOTON. There have to be one or two or a combination of two answers to that.

One, it has to tell you that the pre-ACRS law—and let me emphasize that you are right—if the property is used by the same person or entity that used it before the sale and leaseback transaction, ACRS deductions are not available. It was obviously a good change. But what it tells you is either Bennington or other lessees who have done the same thing have found that the pre-ACRS tax deductions were faster than economic depreciation. And, therefore, while not as beneficial as ACRS, there was benefit in the lease transaction. And in the case of some of the city hall transactions, the rehabilitation credit was available for the expenditures in rehabilitating the building which provides a very significant benefit.

Mr. PEASE. I am concerned in general that we seem in the last couple of years to respond to a whole new industry. The industry's smart lawyers and accountants are figuring out ways to beat the tax code, figuring out ways to market that system and then going out and finding customers.

I am just curious to know from you how many other possibilities you think are out there for similar treatment—obviously in a different section of the code—but similar treatment? Are we going to be spending all of our time on this committee passing bills like this to put out fires that somebody has found, some enterprising lawyer or accountant has found?

Mr. CHAPOTON. I don't think so. This bill would have a very broad sweep. Anything adopted along this line would affect all tax-exempt users. So to the extent that problem exists, it would be taken care of in one fell swoop.

The problem of leasing by taxable entities far predated ACRS, far predated 1981 changes, and it is going to be with us in one form or another for the future. There are business users, taxable users of property who cannot currently use the tax benefits, and they are going to be prompted to engage in leasing transactions. I am not sure that that is a problem.

Mr. **Pease**. Well, thank you very much. I appreciate your testimony and I appreciate the strong support of the Treasury Department for this bill.

Mr. **Dorgan**. Mr. Gradison?

Mr. **Gradison**. Mr. Chairman, I have a quick question.

Assuming a traditional transaction in which a city government leases on a relatively long-term basis Xerox equipment or IBM equipment and this takes effect, will the net effect simply be that they will have to pay more for the lease? They can still enter into it, but the costs will be higher than they otherwise would be?

Mr. **Chapoton**. That is correct. If it is not under the short-term leasing exception, the answer is yes.

Mr. **Gradison**. Thank you.

Mr. **Dorgan**. Mrs. Kennelly?

Mrs. **Kennelly**. No questions, Mr. Chairman.

Mr. **Dorgan**. Mr. Moore?

Mr. **Moore**. Thank you. I want to follow up on my colleague from Ohio's questions.

What is the abuse in changing the ACRS law or changing whatever on the leasing of computer equipment? I can understand the concern of the gentleman from Texas and also the Treasury on leasing sewer systems and leasing streets and courthouses and city halls. I understand that. That is clearly nothing more than an effort to use the tax law to finance things cheaper. It is clearly not intended by the tax law.

But when you had these kind of leases going on for some time where the city government or the State government never intended to buy the computer equipment and always leased this equipment, because the technology and whatever change so fast, we are suddenly changing the rules on something I don't perceive to be—or am I wrong?—that is perceived by Treasury to be the same kind of problem as these other things I have just identified?

Mr. **Chapoton**. It is a difficult analytical problem. I will concede that immediately. It does raise the problem Mr. Gradison pointed out.

You have got to determine whether the tax benefits were intended to flow to nontaxable entities. If you answer that question "No," then you should treat a financing transaction as the equivalent of an acquisition of the property and deny the benefits either directly or indirectly to the tax-exempt user.

Mr. **Moore**. Let's assume that IBM is in the business of leasing one of its big computers for 4 years or just over what the short-term lease is in this bill. What you are saying is that if it leases it to Exxon, it gets all the tax benefits, and if it leases it to the city of Atlanta, it does not. So the rentals will have to be higher to the city of Atlanta.

Mr. **Chapoton**. There is no doubt about it. The leases will have to be higher to the tax-exempt user comparable to the taxable user. The tax-exempt user can finance the transaction in other ways—we make this clear in our testimony—in other ways than through leasing, for example, through the issuance of tax-exempt bonds.

Mr. **Moore**. Let's assume that the non-tax-exempt entity chooses to buy the equipment. I am talking about the situation where they would not buy it under the normal course of commerce, and never have.

Mr. **Chapoton**. But they also can make the lease payment through that financing. The economic effects, I think, come out the same.

Mr. **Moore**. Is that a fairly common thing?

Mr. **Chapoton**. There would be no reason for tax-exempt entities to finance their operations other than through tax-exempt debt and therefore cheaper debt.

There is a question where the user is not entitled to issue tax-exempt debt. However, it is important to bear in mind that the user is not taxable on any income it generates directly or indirectly through the activity.

Mr. **Moore**. You would not be opposed to us being able to work within the committee to see if there is a better way to take out of the consideration of this bill the things that have traditionally been going on in the marketplace that are not part of the perceived problems now?

Mr. **Chapoton**. That is correct. But I stated earlier, that would be a difficult line to draw.

Mr. **Gradison**. It is a difficult problem. I inquired of the city manager what impact it would have, and he said not much. But it could have had an impact if it had been applied earlier. Some time after we passed the law in 1981, the city did enter into some major transactions under safe harbor leases of buses for the transit authority. I don't consider that a particularly unusual transaction to lease buses. Some people might, but I don't. And yet, if you tried to distinguish between the leasing of buses and the leasing of the sewer system, I am not quite sure how you can say that one is really different from the other.

It is a tax consequence that we are worried about; is that not so?

Mr. **Chapoton**. In those cases, there is an exception for mass transit in the bill, but the principle remains the same. The city can already finance the buses with tax-exempt obligations. It receives the benefits of tax-exempt obligations and a passthrough of depreciation benefits. It is receiving almost a double benefit.

Mr. **Gradison**. There is a practical problem. You have touched the point. And I mention this as having served in local government for a long time.

There are many communities for whom the issuance of debt is not a practical alternative because of limitations which they are under, including the State or local law, or the requirement of public vote before debt can be issued. So in a significant number of cases of leasing, it may be the only practical option for them to get around their own debt limitation.

Mr. **Chapoton**. That is correct, Mr. Gradison. But one of the points that we make in our testimony is that leasing is a way around either a limitation of the Federal Government, say, the arbitrage limitation, or a limitation the State government puts on itself. It is a financing technique that is below fully taxable financing, which is part of the problem.

I also point out, in response to the point that both you and Mr. Moore are making, that we have for a long time had in the tax law a rule that denies the use of a credit for property that is leased to tax-exempt entities, so the existence of the rule has already been that for an IBM machine that is leased to a city, the lease rentals are higher. The lessor in that case does not get the credit unless a service contract agreement is involved.

Chairman ROSTENKOWSKI. The time of the gentleman has expired.

Mr. Gephardt will inquire.

Mr. GEPHARDT. Thank you, Mr. Chairman.

I have heard a lot about this bill from people who are doing rehab of housing in St. Louis and other areas. One of their concerns is about the effective date. This discussion has had a chilling effect on the bond attorneys and their willingness to go ahead with projects that probably are not going to be outlawed or prohibited by what we finally pass.

I am wondering what your attitude is about effective dates so that some of the projects that are ongoing wouldn't be stopped?

Mr. CHAPOTON. Well, the bill attempts to draw a grandfather clause. We all have problems with effective dates. Ideally, the effective date would be on the date of announcement but with protection for people who are committed. As a matter of principle, that is easy to state but very hard to apply.

We know what is going to happen. We will all hear from people who do not have a binding contract but do feel financially committed, and we will hear some very sympathetic cases, and I suspect we ought to respond to those sympathetic cases.

Mr. GEPHARDT. I would also like to ask about your attitude. I am sorry I have not finished reading your testimony. It may be covered.

The concern is that this has an impact not on what I think most people agree are abuses, but on the impact of a lot of work that is being done in inner cities where there is the combination of use of different tax incentives including the 25-percent historical tax incentive.

I am wondering, did you cover that in your testimony?

Mr. CHAPOTON. In our testimony, we point out that the 25-percent credit for rehabilitation ought to be looked at closely. The principal reason is that when you look at the 1981 act, it does seem that Congress clearly anticipated that credit would be available for the tax-exempt user. And while that credit alone may generate some of this activity that we would all agree could give us concern, the leasing of city hall, we think we need to look at the issue further.

Mr. GEPHARDT. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. I am having just a little trouble with the philosophy. Buses are permitted, as we want to pass tax incentives along to insure transportation——

Mr. CHAPOTON. Let me interrupt. Buses are being permitted in this bill because it was a conscious decision in 1981 to pass tax benefits to those type of transactions. Absent the provision in 1981, it would not have been entitled to the benefits of ACRS under the bill.

Mr. GUARINI. But we are still going to leave buses alone, and philosophically we are favoring buses with our tax laws by leaving mass transit out of this act; is that correct?

Mr. CHAPOTON. That is correct.

Mr. GUARINI. Could we give that same example to Xerox machines in city halls or residential properties being converted to YMCAs, so we are really giving preference to buses that we are not giving to other basic needs in inner cities? Is that correct?

Mr. CHAPOTON. That is correct.

Mr. GUARINI. As I understand, the investment tax credit was enacted in 1962 and says here, "It was designed to stimulate expansion of the Nation's productive facilities by reducing net costs of acquiring new equipment."

What we really did that for was to have an expansion of our productivity so that we would have new equipment made that would keep our factories going. Now, philosophically, if you allow that with buses, why not with Xerox machines or with other kinds of equipment that a city would need to use, assuming that there are new materials that are being used? Does not that give jobs and add to the productivity, which was the purpose of our 1962 tax credit law?

Mr. CHAPOTON. You are touching on a question that does deserve a lot of review. But I think the answer has to be that when the credit was adopted, it was adopted to reduce the tax disincentive for a capital investment, and indeed it was recognized when adopted that it should not be available where the property is used by a non-taxable user.The mass transit exception in the 1981 act was a clear turning away from that principle.

Mr. GUARINI. You see, the question I have is that you allow it in one area of Government but not in the other area of government. It seems to me an inconsistency in our position.

Mr. CHAPOTON. There is no way to draw a rational line once you start down that road. I would agree with that.

Mr. DORGAN. Would the gentleman yield on that point?

Mr. GUARINI. Yes, sir.

Mr. DORGAN. You raise an interesting point about the investment tax credit. I think everyone here would agree that the sale of an existing city hall is not the production of any new wealth. We agree that ought to be stemmed.

The question of the buses: This is a form of revenue sharing to the extent that that kind of transaction gets preferred tax treatment, and the lease the city would pay for those buses represents a lower figure because of the presence of the certain tax benefits that the private investors can pass along.

It seems to me that when Congress wants to adopt revenue sharing, we ought to debate revenue sharing. But there is a tendency to want to do everything in the Tax Code.

I understand the question you are asking the Assistant Secretary, but I think we need to plug some holes here, and the question is where do you draw the line?

Mr. GUARINI. I am trying to understand the consistency of the philosophy which underlines our tax policy. We can give tax exemptions or bonds to buy city property or Xerox machinery and computers and things like that, which you would get by reason of tax exemption 1 or 2 percent less cost on the bond. But it could be much more preferable if they were able to pass through a tax exemption which industry enjoys, because then you would get a much cheaper cost to the public. The other gives you a much more measurable difference, so that we would end up paying more money for our city hall computers and equipment than private industry would be.

Mr. **Dorgan**. The point that we are making about the Navy purchase of the ships demonstrates that when you have a buy or lease decision, generally speaking, the buy decision saves the taxpayers money. You are saying you provide some tax incentives to encourage this for a lower lease payment by the Government, and I am saying that, in the aggregate, all governments end up losing money, and I am not sure that is a very wise decision by government.

Mr. **Guarini**. Well, the inconsistency is that you will cost the city hall more money for the same piece of equipment if you look at hard dollars than it would cost an industry across the street from city hall, and in the long run it is the taxpayers that are paying that additional money.

Now, of course, there is a fine line that has to be drawn, but it does seem to me to look wrong if the city is paying more money for the same equipment than, say, the textile industry would be paying for the same piece of equipment.

Mr. **Chapoton**. The city is entitled to finance that equipment with tax-exempt financing which has even a greater benefit than the leasing transaction and with taxes that are deductible for Federal tax purposes.

Mr. **Guarini**. They can get cheaper percentages of the tax-exempt bonds by a point or two, but the greatest amount of benefit would be if you could pass through the tax credit.

Mr. **Chapoton**. No. I think the benefit under tax-exempt financing would exceed the benefit under leasing.

Mr. **Guarini**. All right. Thank you.

Chairman **Rostenkowski**. Mr. Secretary, in your view, is it appropriate for the United States to claim accelerated depreciation on an airplane lease to a foreign airline if that airplane is neither manufactured in the United States nor used in the United States?

Mr. **Chapoton**. There are a lot of special rules dealing with transportation equipment. I cannot unqualifiedly say whether it is appropriate or not. We do not have a test in any of the credits that requires the property to be manufactured in the United States, and I don't think that it would be a proper criteria. The criteria of where the property is used, which is a test we do have in the tax law generally, is that it ought to be used here. Once we decide that the property and transportation or airline equipment can not be used outside the United States, then I think we should not apply an additional test of where it is manufactured.

Mr. **Pickle**. We mentioned this earlier, and I want to get additional information about how you would work there. You agreed on the premise that we should not permit ITC or ACRS to foreign governments or foreign owned companies. I think we agree on that as a principle.

Now, you want to maybe make some exception if I get the answer you have given Mr. Rostenkowski, and I am trying to find out how you want it. I am advised that a group of Americans now could go to France and buy a French Airbus and lease it to Saudi Arabia and get the ITC and the ACRS in the process. Now, is that so?

Mr. CHAPOTON. Let me answer this. Generally, if it is used abroad, it is not eligible for the credit. Let me inquire just a minute.

If it is registered with the CAB, even a foreign airline, if it is registered and used in transport to and from the United States, it would qualify for the credit, which is an exception to the general rule that if it is used outside the United States it does not qualify for the credit.

Mr. PICKLE. Do you approve of that?

Mr. CHAPOTON. I would have to look at it much closer. I would be worried about our domestic airlines—Pan American, for example—if we suddenly said that property used outside the United States could not qualify for the credit.

Chairman ROSTENKOWSKI. Mr. Secretary, we are talking about equipment used exclusively outside the United States.

Mr. CHAPOTON. I think it receives the credit now only if it is engaged in transportation to and from the United States. But whatever rule we devised I am afraid would have to apply to a domestic airline as well, so I would want to examine that more closely if we talk about denying the tax credit to Pan Am, United, and those airlines.

Mr. PICKLE. Mr. Secretary, we have got to ask ourselves if it is right that we allow the ITC and ACRS, in cases like the Airbus, when that equipment is made outside the United States, and yet we give our investors the full ITC and full ACRS. Now, I don't think you are endorsing that. If you say the blanket rule that if it is registered with the CAB and flies to and from the United States, then we will get it, then you have been pretty lenient, it seems to me.

I think we ought to ask ourselves how to best handle these things.

Mr. CHAPOTON. I think that is an exception that has been studied before and can be reviewed again. We have to watch what happens to our domestic airlines. I also question whether we should start down the road of saying that credit is not available unless the property is manufactured here. That, I think, would be a dangerous track to start down. We have never had that rule, and it would seem that it would not be advisable. Other countries would quickly retaliate.

Mr. PICKLE. Let me ask a question at this point. When you talk about those kind of instances with foreign government, I want to know specifically what you are recommending here when you talk about the transition date and effective days. When you say we ought to look at that further, I appreciate that. If you have any recommendation, I want you to submit it to us in writing and give us a chance to work with it, and we want to know immediately.

Mr. CHAPOTON. Mr. Pickle, the only thing we are leaving open on the foreign use of property is not its use by a foreign government but a foreign taxable entity. If the foreign entity is tax exempt, we agreed with the bill. And if it is a foreign taxable entity, we will submit our recommendation on that.

On the transitional rule, we agree with the rule except for the special rule that applies to the Federal Government.

Chairman ROSTENKOWSKI. Mr. Chapoton, we will need that recommendation fairly soon.

Mr. CHAPOTON. That will be fine. We will be in a position to provide that.

Chairman ROSTENKOWSKI. We look forward to your recommendation.

[No further information was provided for the record.]

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you, Mr. Chairman.

Mr. Chapoton, I would like to return to the question of leasing by the Federal Government. You say in your statement that the allowance of ACRS and the investment credit on assets leased to the Federal Government per se has no real budget impact in the budget process.

Are you assuming that we would show the loss of revenue from a particular transaction somehow in the Federal budget?

Mr. CHAPOTON. We should show it. We are saying it should be budgeted for directly. It should show up on the budget of the user of the property, both the lease cost and the revenue costs. We do not do that now, and it should be done. But as far as overall budget is concerned, providing the lease transaction is efficient, the Federal deficit will not be larger by reason of a lease transaction.

Mr. PEASE. So you are recommending, in effect, that the revenue loss from a ship leased by the Navy should show up on the Navy's budget rather than just as a general loss to the Treasury?

Mr. CHAPOTON. It should be. It is really an OMB question of whether it actually shows up on their budget or not. But it certainly should be accounted for in budgeting their cost of that equipment. So the answer to your question is "yes."

Mr. Pease, I might say that process, of course, can be done administratively without regard to what the tax rules are, and we are working with OMB to attempt to adopt a circular on budgeting for those matters.

Mr. PEASE. In relation to your statement just now that there would be no effect on the Federal deficit, for example, is that really true? In the leasing arrangement, presumably the leasing arrangement includes some profit to the lessor in addition to whatever tax advantages are passed along.

Would not the overall effect be a higher cost to the Navy than if there were a direct purchase?

Mr. CHAPOTON. That is a question that has been discussed at some length within the administration. That is what I meant when I said to the extent that it is inefficient; that is, to the extent that part of the tax benefit remains with the lessor, the overall cost would be higher. If the lessee negotiates hard enough to get all that tax benefit passed through, the cost is no higher.

Mr. PEASE. If that is the case, then why would the lessor engage in the practice?

Mr. CHAPOTON. To the lessor the lease is just another method of financing the property.

Mr. PEASE. I see.

Thank you very much.

Chairman ROSTENKOWSKI. Mr. Dorgan will inquire.

Mr. DORGAN. Just one more question.

We know there are special rules for transportation and communications, and I would like to inquire about them. A U.S. bank or a U.S. leasing company can purchase a communications satellite that was produced in Japan, can lease it then to a company in France that will use it—produced in Japan, used in France—and, yet, has no other contact with the United States except the fact that a U.S. bank financed it and a leasing company consumed the transaction.

As I understand that situation, the U.S. lessor is entitled to the investment tax credit and the ACRS benefits which ostensibly will be passed in part along in lower lease payments to the company in France that is operating it. Here is a situation which would produce jobs in Japan, jobs in France, and would produce no tax revenue to the United States. In fact, the Treasury would lose money.

Is there any standard of tax policy by which you would consider that acceptable?

Mr. CHAPOTON. I think that transaction would give me a great deal of concern. I see how that arose when we exempted from the denial of the investment tax credit for property used outside of the United States, communication equipment, with specifically in mind, I think, the COMSAT satellite, but I think you described a case that would give rise to concern.

Mr. DORGAN. Would you be prepared, then, to submit some recommendations to us on how to tighten that area? I interpret the words "great concern" to mean in North Dakota language we better do something about it!

Mr. CHAPOTON. I would like to look at it further. I can't say unqualifiedly how we would come out. I think it should be examined further.

Mr. DORGAN. The question is about acceptable tax policy. It seems clear to me that if we have the production in Japan, the use of the product in France, and the only contact in the United States is a leasing company that takes American tax dollars from our Treasury to pass them on in lease costs to a French company, that that is an unacceptable use of our Tax Code and our taxpayers' dollars. We ought to plug that hole. I would hope that you will give us some recommendations on how to do it.

Mr. CHAPOTON. We will look at that and give some recommendations.

Chairman ROSTENKOWSKI. The time of the gentleman has expired. Do you have another question, Mr. Guarini?

Mr. GUARINI. Are there any tax treaties that are in effect now that would involve the very thing that we are discussing? Would we be abrogating certain arrangements with foreign governments as a result of this proposed bill?

Mr. CHAPOTON. Well, some tax treaties exempt from U.S. tax certain income under the theory that it is taxed in the foreign country. So if we have a rule that requires a longer depreciation schedule if property is used by someone or leased to someone not subject to U.S. tax, we should be careful to make sure that that does not apply mechanically to an entity that is not subject to U.S. tax merely because of a treaty. So I think there is an interplay there.

Mr. GUARINI. Thank you.

Chairman ROSTENKOWSKI. Thank you very much, Mr. Chapoton.

The chair calls Mr. Verdier. Welcome, Mr. Verdier. If you will proceed with your testimony, the committee will be happy to receive it.

STATEMENT OF JAMES VERDIER, ASSISTANT DIRECTOR, TAX ANALYSIS DIVISION, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY PEARL RICHARDSON, SENIOR ANALYST

Mr. VERDIER. Thank you very much, Mr. Chairman. With me is Pearl Richardson, who is a senior analyst in the Tax Analysis Division of the Budget Office.

I have a prepared statement which I am going to skip portions of and summarize portions of.

Chairman ROSTENKOWSKI. If you would like to summarize, your entire statement will be included in the record.

Mr. VERDIER. Thank you, Mr. Chairman. The potential revenue losses to the Federal Government from sale-leasebacks involving nontaxable entities are extremely large. Governments and tax-exempt organizations currently own nearly $1 trillion in property that could be transferred to private investors and then leased back.

The only real limit on the potential extent of this activity is the capacity of private investors to absorb the tax deductions and credits that sale-leasebacks make available. There are only so many people in high tax brackets.

As a possible solution to the problems that the committee confronts with sale-leasebacks, nontaxable entities could simply be denied the benefits of the capital investment subsidies that are provided through the tax code—accelerated depreciation that exceeds real economic depreciation plus investment tax credits for building rehabilitation.

But if these subsidies are intended to encourage activity such as investment in plant and equipment and rehabilitation of buildings and they are not really designed to measure taxable income as would be, for example, deductions for wages and salaries and real economic depreciation, then what is the rationale for denying them to nontaxable entities?

Subsidies are used to enable some activity to be performed and it ought not, if that is the purpose, make any difference whether an entity is taxable or not.

The Congress could simply decide that the Tax Code is not an appropriate vehicle for delivering subsidies to nontaxable entities since there are existing Federal programs that offer alternative ways of providing such subsidies—revenue sharing, urban development action grants and the like—and there are also administrative problems in providing subsidies through the Tax Code to nontaxable entities as well as the inefficiencies inherent in having to go through arrangements like sale-leasebacks.

I will return to both of these points later in my testimony because they are central to what we are saying.

The testimony will cover three areas: The growing use of sale-leasebacks as a financing mechanism; the tax and budget policy implications of sale-leasebacks; and some alternatives that the Congress may want to consider.

Sale-leasebacks provide municipalities with means of raising funds that may be less costly than issuing general obligation bonds.

The lower costs result from returns that the municipality receives from investing the payment made by the private investors, plus the portion of tax benefits that private investors will pass on to the municipalities in the form of lower rental fees.

They have another advantage. Current law places limits on a municipality's ability to issue tax-exempt bonds and invest the proceeds in higher yielding taxable securities. But no limits are placed on investment of the proceeds from the sale of property.

In choosing a sale-leaseback over general obligation financing, a State or locality can, in effect, get around the arbitrage provisions in current law.

What they are doing, really, is exchanging a low yielding asset such as a building or something of that sort for a higher yielding taxable asset, and the potential for that sort of activity is quite large because as long as there is that differential between the yield on the assets that the nontaxable entities hold and the assets that they can invest in, there is an incentive to do that.

So far, most sale-leaseback arrangements have involved the rehabilitation of existing property or the construction of new facilities, but their usefulness as a means of raising funds is similar whether capital improvements are undertaken or whether the transactions are simple transfers of ownership.

In either case, the private investors can claim depreciation deductions, and the nontaxable institution receives a cash payment that can be invested in high-yielding securities or used to retire existing debt.

The depreciation deductions are generally lower in the case of simple transfers, however.

Sale-leaseback transactions are generally quite complex, and not many have actually been completed. The numbers are growing, however. Many municipalities are looking into sale-leasebacks, particularly for historic structures. So are tax-exempt nonprofit institutions, particularly universities.

As a result of the Economic Recovery Tax Act of 1981, State and local governments and other tax-exempt entities now have a much stronger incentive to sell property to private investors than in the past.

The new accelerated cost recovery system permits much shorter recovery periods for equipment and buildings than were allowed under prior law. In addition, ERTA provides generous investment tax credits ranging from 15 to 25 percent for the rehabilitation of buildings over 30 years old or of historic significance.

It has always been more beneficial for governments and other nontaxable entities to lease, rather than own, tax-favored assets, since ownership confers no benefits from the special tax advantages.

Before 1981, however, the tax advantages available for property used by nontaxable entities were quite limited. With a few exceptions, the investment tax credit was not permitted for property used by governments or tax-exempt organizations, and accelerated depreciation allowances were generally not large enough to induce nontaxable entities to enter into special arrangements to take advantage of them.

The 1981 act changed this, however. Although the regular 10-percent investment tax credit is still not allowed for property used by nontaxable entities, the new tax credits for rehabilitation of older and historic buildings were specifically extended to property leased to governments or tax-exempt organizations.

In addition, the depreciation allowances permitted by ACRS are now so large that nontaxable entities are almost required to use them.

The combination of ACRS and deductions for interest can reduce the effective tax rate below zero for many assets owned by taxable entities, giving them a major advantage in the competition for resources over nontaxable entities unless nontaxables can somehow benefit from these provisions themselves.

The sale-leaseback arrangements that have grown up in the last 2 years are thus a direct consequence of the 1981 act. They raise three major tax and budget policy questions

One, to what extent is the Tax Code an appropriate mechanism for the delivery of subsidies for investment in equipment and buildings?

Two, how large should Federal subsidies be for State and local governments and tax-exempt organizations?

Three, what effects does the extension of subsidies through the tax system have on the allocation of resources generally?

With respect to subsidy delivery mechanisms, as noted earlier, the regular investment tax credit has never been permitted for property used by governments or tax-exempt organizations.

The original rationales for that denial are not especially compelling. The purpose of the investment tax credit is to encourage business investment by, in effect, reducing the purchase price of machinery and equipment.

The credit was denied to governments on the theory that their demand for equipment is not sensitive to price, and to tax-exempt organizations on the theory that they might improperly use the credit to reduce the taxes due on unrelated trade or business income.

Another possible justification for denying the credit to governments and tax-exempt organizations is that these entities do not generally use machinery and equipment for additional production as many private sector industries do.

But many private taxable entities do not use their equipment for additional production either; they use trucks and typewriters and computers in the same way that nontaxable entities do, but they get the investment tax credit while nontaxable entities do not.

If the investment tax credit is viewed simply as a subsidy designed to encourage a particular type of activity, it is difficult to see why in principle it should not be available to any entity that can perform the activity, regardless of whether that entity has any tax liability.

That, at least implicitly, is the approach the Congress took in 1981 when the rehabilitation tax credits were extended to property leased to nontaxable entities.

The Congress wanted to encourage rehabilitation of older buildings in central cities and a lot of those were owned by municipalities. A lot of rehabilitation activity is in the central cities where those older buildings are, so the subsidies were extended to those who could make the best use of them.

The Congress has never been willing to pursue this approach to its logical conclusion, and for good reasons. To do so would require converting the investment tax credit to a direct grant or making it fully refundable with all entities, taxable or not, fully eligible.

The resulting revenue loss would be very large. In addition, substantial administrative problems would arise in determining eligibility and auditing improper claims, especially for those entities not already in the tax system.

For taxable entities, providing a capital investment subsidy through the tax system has administrative advantages, since they are already required to file tax returns containing most or all of the information required to determine eligiblity, and their returns are subject to normal IRS audit.

This is not the case for governments and other nontaxable entities. Governments are not in the tax system at all, and the IRS does not give the returns filed by most tax-exempt organizations the same kind of attention as those filed by taxable entities.

So if you wanted to provide a subsidy through them, you would have to supply additional resources to the IRS.

In addition, a great variety of Federal direct grant or loan programs already extend assistance to nontaxable entities: revenue sharing, community development block grants, urban development action grants, college housing loans, sewage treatment grants and the like.

Moreover, using the Tax Code to assist nontaxable entities in the way it is now done requires complicated and elaborate leasing arrangements that divert part of the subsidy to investment bankers, lawyers, accountants, and other intermediaries needed to arrange the deal.

This leakage makes the subsidy delivery mechanism less efficient. As a result, the Congress may very well decide that subsidy delivery mechanisms other than the Tax Code are more appropriate for nontaxable entities, and thus deny them any direct or indirect use of investment tax credits.

The question becomes more difficult in the case of accelerated depreciation deductions. Only a portion of ACRS can be considered a subsidy, but it is hard to know how large that portion is.

In theory, any depreciation allowance that exceeds the real economic depreciation of the asset can be viewed as a subsidy. The measurement of real economic depreciation is subject to great uncertainty, however.

Given the uncertainty involved, rough approximations may be appropriate for legislative purposes. The bill now before this committee, H.R. 3110, follows this approach by requiring property used by nontaxable entities to be depreciated over extended recovery periods of from 5 to 35 years, which is probably a good approximation of economic depreciation.

The Treasury objects, I think properly, to some of the features of that. It may not be as close an approximation as you can get.

Once the appropriate subsidy delivery mechanism is decided, the next question is the size of the subsidy, given scarce Federal resources. If this committee decides to exclude governments and tax-exempt organizations from tax subsidies completely, the question then becomes one for the committees with jurisdiction over direct grant and loan programs. They decide how big they should be.

If subsidies are provided through the Tax Code, however, this committee has to consider the size of the potential revenue loss, and that is hard to get at.

If you look at the illustrative transaction in the paper that we submitted earlier, you can see that the revenue loss from combining a sale-leaseback with tax-exempt bond financing is about twice as large as the revenue laws from tax-exempt bond financing alone, and in some cases more than twice as large.

The paper gives the example of a deal in which the present value of the revenue losses from a $4 million rehabilitation of city hall were $1.1 million over 20 years in the case of just general obligation bond financing and $2.6 million when sale-leasebacks were combined with tax-exempt bond financing.

Although revenue losses from sale-leasebacks have been minimal so far because of the limited number of transactions that have been completed, the potential future losses are significant. Since sale-leasebacks typically result in lower borrowing costs for municipalities, the incentive to use them instead of general obligation bonds is strong, and the potential for transferring ownership of facilities is vast.

As of 1981, the net stock of State and local schools, hospitals, police and fire stations, courthouses, auditoriums, office buildings and water supply and sewer systems, plus property owned by tax-exempt organizations, was valued at nearly $1 trillion.

Sale of even a small fraction of these assets to private parties, with a leaseback to the former nontaxable owner, would result in tax reductions far exceeding anything contemplated in current baseline revenue estimates.

As indicated earlier, there is a major incentive for the transfer of these existing assets to taxable entities because of the arbitrage profits that can be obtained by the nontaxable entity.

Even if the subsidy is limited to new construction or rehabilitation of older buildings, the potential revenue loss is substantial. State and local governments accounted for about $22 billion in new construction in 1981, about 13 percent of total new construction in the economy that year.

To give an example of how the volume of sale-leaseback activity relates to the revenue loss, if sale-leasebacks amounted to $2 billion in 1984 and increased to $10 billion by 1988, the resulting revenue losses would be roughly $100 million in fiscal year 1984, rising to approximately $1.5 billion by fiscal year 1988.

This is simply an illustration. We think the activity, if it is unconstrained, would be larger than that.

Mr. **Pickle**. Where are you reading from now?

Mr. **Verdier**. I am reading at the bottom of page 10. I am sorry. Getting to the effects on the allocation of resources on the bottom of page 10. The main limits on sale-leaseback financing are the complex nature of the transactions, which should ease as the practice becomes more widespread and familiar, and the demand for such tax shelters by high-income investors.

Sale-leasebacks would appeal to the same high-income taxpayers who invest in real estate and other tax shelters, and in tax-exempt bonds. There really is a competition for resources here and a competition for investors.

There are only, as I indicated earlier, a limited number of potential investors in this, and sale-leaseback activity competes with real estate tax shelters, oil and gas tax shelters and any other kind of tax-favored investment.

Whether the Congress wants to encourage this kind of reallocation of investment resources is an issue that should be directly addressed.

Turning to the policy alternatives. H.R. 3100 would deny nontaxable entities a substantial portion of the ACRS depreciation deductions by requiring that property used by them be depreciated over longer recovery periods than are now permitted under ACRS.

As we read the bill, these recovery periods only apply to a relatively small amount of the activity that would occur and does not really apply to existing assets that were owned by the cities prior to 1980, because they are required to use old-law depreciation, pre-1980 depreciation for those assets. For newly constructed assets, those constructed after the effective date of the bill, as long as they are not financed with industrial revenue bonds, and as long as it is a genuine lease they are entitled, as we read the bill, to the shorter ACRS recovery periods.

So it really is only assets that municipalities constructed between 1980 and 1983 and owned that would be significantly affected by this lengthening of the depreciation periods.

The special tax credits for rehabilitation of old or historic buildings would continue to be allowed for buidings used by governmental units or tax-exempt organizations, but these tax credits could not be combined with tax-exempt IRB financing.

This suggests a view that, while it may be appropriate to provide a subsidy through the Tax Code to encourage nontaxable entities to rehabilitate older buildings, the total Federal subsidy should be limited. It is too large when you combine the credits with the IRB financing.

These measures would sharply reduce the use of sale-leaseback financing techniques. As a consequence, however, property used by nontaxable entities would receive a lower total Federal subsidy than is received by comparable property used by taxable entities.

As indicated earlier, if the Congress wants to provide equivalent subsidies for nontaxable entities, it could do so by providing grants or low-interest loans under existing or new programs, thereby avoiding the administrative problems and inefficiencies of using the tax system.

Finally, the approach taken by H.R. 3110 is simply to cut back on the use by tax-exempt entities of the generous tax subsidies provided by ACRS and the rehabilitation tax credits.

The potential heavy use of these subsidies by nontaxable entities suggests, however, that the subsidies themselves may be unduly large in a period when Federal resources are scarce.

If so, reduction in these subsidies for all users might be an appropriate way of simultaneously reducing the incentives for sale-leasebacks and raising some of the revenue needed to deal with projected long-term budget deficits.

If, for example, ACRS depreciation for buildings was extended from 15 to 20 years and limited to straightline for all users, revenues would be increased by $3.8 billion in fiscal year 1986 and $7.8 billion in fiscal year 1988.

If the rehabilitation tax credits were scaled back to 10 percent for buildings more than 30 years old and 15 percent for certified historic structures, revenues would be increased by $600 million in 1986 and by nearly $800 million in 1988.

Thank you.

[The prepared statement follows:]

STATEMENT OF JAMES M. VERDIER, ASSISTANT DIRECTOR, TAX ANALYSIS DIVISION, CONGRESSIONAL BUDGET OFFICE

In the past few years, local governments and nontaxable entities have begun to use with increasing frequency a financing mechanism known as a sale-leaseback, which enables them to benefit from tax deductions normally available only to the private sector. Under sale-leaseback agreements, a local government or a tax-exempt institution sells real property, such as a museum or a library, to private investors and simultaneously leases it back. The local government or tax-exempt institution--which can be a university, foundation, or church--gets a cash payment from the investors and an opportunity to lease back the facility at a reduced rate reflecting the owner's tax benefits.

Sale-leasebacks can be used for all manner of facilities from college campuses to city halls. In the past year, Bennington College has arranged to lease its campus from private investors and will use the cash payment to retire a bank loan. Towson State University in Towson, Maryland, has arranged a sale-leaseback to finance the construction of new dormitories. The City of Oakland has sold and leased back a museum and an auditorium, which will be converted into a convention center. And the City of Atlanta is reportedly considering a sale-leaseback to finance the rehabilitation of its city hall.

The potential revenue losses to the federal government from sale-leasebacks involving nontaxable entities are extremely large. Governments and tax-exempt organizations currently own more than $2 trillion in property that could be transferred to private investors and then leased back. The only real limit on the potential extent of this activity is the capacity of private investors to absorb the tax deductions and credits that sale-leasebacks make available.

Nontaxable entities could simply be denied the benefits of capital investment subsidies that are provided through the tax code. This raises some difficult questions, however. If these subsidies--accelerated depreciation in excess of real economic depreciation plus investment tax credits for building rehabilitation--are intended primarily to encourage investment in plant, equipment, and rehabilitation rather than to measure taxable income, why should it matter whether or not the entity making the investment is taxable? The Congress could decide, of course, that the tax code is not the appropriate vehicle for delivering subsidies to nontaxable entities, since existing federal programs offer alternative vehicles that avoid the administrative problems and inefficiencies of using the tax system.

My testimony this morning will cover three areas:

- The growing use of sale-leasebacks as a financing mechanism;
- Tax and budget policy implications of sale-leasebacks; and
- Policy alternatives that the Congress may wish to consider.

CBO has prepared for the record a more detailed paper on recent trends in municipal leasing. This statement will briefly summarize some of the main points of that report.

THE GROWING USE OF SALE-LEASEBACKS

In the past few years, as budget pressures have grown more severe at the state and local level, leasing has become an increasingly important municipal financing tool. In general, the trend in municipal financing has been away from traditional general obligation bonds and toward mechanisms that make it possible to avoid seeking voter approval and to raise funds without being subject to established debt limits. The growth in the use of revenue bonds and, more recently, innovations in municipal leasing are manifestations of the search for new funding sources.

Sale-leasebacks provide municipalities with a means of raising funds that may be less costly than issuing general obligation bonds. The lower costs result from the returns that the municipality receives from investing the payment made by the private investors plus the portion of tax benefits that private investors will pass on to the muncipality in the form of lower rental fees. Sale-leasebacks have another advantage: current law places limits on a municipality's ability to issue tax-exempt bonds and invest the proceeds in higher-yielding taxable securities. But no limits are placed on investment of the proceeds from the sale of property. In choosing a sale-leaseback over general obligation financing, a state or locality can in effect get around the arbitrage provisions in current law.

So far, most sale-leaseback arrangements have involved the rehabilitation of existing property or the construction of new facilities, but their usefulness as a means of raising funds is similar whether capital improvements are undertaken or whether the transactions are simple transfers of ownership. In either case, the private investors can claim depreciation deductions, and the nontaxable institution receives an cash payment that can be invested in high-yielding securities or used to retire existing debt. The depreciation deductions are generally lower in the case of simple transfers, however.

Typically, sale-leasebacks involve at least four primary participants:

- A municipality, county, state, or tax-exempt organization, which owns and will subsequently lease back the property;
- A private investor;
- An underwriter, or lender; and
- A public authority, which will issue tax-exempt industrial revenue bonds to finance acquisition and construction costs.

Sale-leaseback transactions are generally quite complex, and not many have actually been complet~~ed. The nu~~mbers are growing, however. Many municipalities are looking into sale-leasebacks, particularly for historic structures. So are tax-exempt nonprofit institutions, particularly universities.

TAX AND BUDGET POLICY IMPLICATIONS

As a result of the Economic Recovery Tax Act of 1981 (ERTA), state and local governments and other tax-exempt entities now have a much stronger incentive to sell property to private investors than in the past. The new Accelerated Cost Recovery

System (ACRS) enacted in ERTA permits much shorter recovery periods for equipment and buildings than were allowed under prior law. In addition, ERTA provides generous investment tax credits ranging from 15 to 25 percent for the rehabilitation of buildings over 30 years old or of historic significance.

It has always been more beneficial for governments and other nontaxable entities to lease, rather than own, tax-favored assets, since ownership confers no benefits from the special tax advantages. Before 1981, however, the tax advantages available for property used by nontaxable entities were quite limited. With a few exceptions, the investment tax credit was not permitted for property used by governments or tax-exempt organizations, and accelerated depreciation allowances were generally not large enough to induce nontaxable entities to enter into special arrangements to take advantage of them.

The 1981 act changed this, however. Although the regular 10 percent investment tax credit is still not allowed for property used by nontaxable entities, the new tax credits for rehabilitation of older and historic buildings were specifically extended to property leased to governments or tax-exempt organizations. In addition, the depreciation allowances permitted by ACRS are now so large that nontaxable entities are almost required to use them. This is because the combination of ACRS and deductions for interest can reduce the effective tax rate below zero for many assets owned by taxable entities, giving them a major advantage in the competition for resources over nontaxable entities unless nontaxables can somehow benefit from these provisions themselves.

The sale-leaseback arrangements that have grown up in the last two years are thus a direct consequence of the 1981 act. They raise three major tax and budget policy questions:

- To what extent is the tax code an appropriate mechanism for the delivery of subsidies for investment in equipment and buildings?
- How large should federal subsidies be for state and local governments and tax-exempt organizations?
- What effects does the extension of subsidies through the tax system have on the allocation of resources generally?

Subsidy Delivery Mechanisms. As noted earlier, the regular investment tax credit has never been permitted for property used by governments or tax-exempt organizations. The original rationales for that denial are not especially compelling. The purpose of the investment tax credit is to encourage business investment by, in effect, reducing the purchase price of machinery and equipment. The credit was denied to governments on the theory that their demand for equipment is not sensitive to price, and to tax-exempt organizations on the theory that they might improperly use the credit to reduce the taxes due on unrelated trade or business income.

Another possible justification for denying the credit to governments and tax-exempt organizations is that these entities do not generally use machinery and equipment for additional production as many private-sector industries do. But many private taxable entities do not use their equipment for additional production either;

they use trucks and typewriters and computers in the same way that nontaxable entities do, but they get the investment tax credit while nontaxable entities do not.

If the investment tax credit is viewed simply as a subsidy designed to encourage a particular type of activity, it is difficult to see why in principle it should not be available to any entity that can perform the activity, regardless of whether that entity has any tax liability. That, at least implicitly, is the approach the Congress took in 1981 when the rehabilitation tax credits were extended to property leased to nontaxable entities.

The Congress has never been willing to pursue this approach to its logical conclusion, and for good reasons. To do so would require converting the investment tax credit to a direct grant or making it fully refundable, with all entities, taxable or not, fully eligible. The resulting revenue loss would be very large. In addition, substantial administrative problems would arise in determining eligibility and auditing improper claims, especially for those entities not already in the tax system. For taxable entities, providing a capital investment subsidy through the tax system has administrative advantages, since they are already required to file tax returns containing most or all of the information required to determine eligibility, and their returns are subject to normal Internal Revenue Service (IRS) audit.

This is not the case for governments and other nontaxable entities. Governments are not in the tax system at all, and the IRS does not give the returns filed by most tax-exempt organizations the same kind of attention as those filed by taxable entities. In addition, a great variety of federal direct grant or loan programs already extend assistance to nontaxable entities: revenue sharing, community development block grants, urban development action grants, college housing loans, sewage treatment grants, and the like. Moreover, using the tax code to assist nontaxable entities in the way it is now done requires complicated and elaborate leasing arrangements that divert part of the subsidy to investment bankers, lawyers, accountants, and other intermediaries needed to arrange the deal. This leakage makes the subsidy delivery mechanism less efficient. As a result, the Congress may very well decide that subsidy delivery mechanisms other than the tax code are more appropriate for nontaxable entities, and thus deny them any direct or indirect use of investment tax credits.

The question becomes more difficult in the case of accelerated depreciation deductions. Only a portion of ACRS can be considered a subsidy, but it is hard to know how large that portion is. In theory, any depreciation allowance that exceeds the real economic depreciation of the asset can be viewed as a subsidy. The measurement of real economic depreciation is subject to great uncertainty, however. As alternative approaches, the subsidy portion could be viewed as any amount in excess of what was allowed for depreciation before 1981, or any amount that pushes the effective tax rate on the asset below zero. Given the uncertainty involved, however, rough approximations may be appropriate for legislative purposes. The bill now before this Committee, H.R. 3110, follows this approach by requiring property used by nontaxable entities to be depreciated over extended recovery periods of from 5 to 35 years, which is probably a good approximation of economic depreciation.

Size of the Subsidy. Once the appropriate subsidy delivery mechanism is decided, the next question is the size of the subsidy, given scarce federal resources. If this Committee decides to exclude governments and tax-exempt organizations from tax subsidies completely, the question then becomes one for the committees with jurisdiction over direct grant and loan programs. If subsidies are provided through the tax code, however, this Committee has to consider the size of the potential revenue loss.

The revenue losses from sale-leasebacks depend on the nature of the transaction. Assuming that a municipal sale-leaseback takes the place of tax-exempt financing that would otherwise occur and that the private investors borrow funds at conventional rates, any net losses to the federal government would be limited. The savings from not issuing tax-exempt municipal bonds would largely offset the revenues forgone from the equity investors' depreciation deductions. Much more typically, however, sale-leasebacks involve the issuance of tax-exempt industrial revenue bonds (IRBs) to finance property acquisition and rehabilitation. In these instances, the tax losses are substantially greater than those resulting from general obligation financing because they include the revenues forgone from issuing IRBs, coupled with the value of depreciation deductions and, in some cases, investment tax credits. With general obligation bonds, the costs to the federal government are the revenues forgone from not collecting taxes on the interest income of the securities. These same losses are incurred whenever a project is financed with tax-exempt IRBs. Accordingly, a sale-leaseback involving IRB financing will always be more costly to the federal government than general obligation financing. The additional expense results from the revenues forgone from depreciation deductions and investment tax credits, where available.

Although revenue losses from sale-leasebacks have been minimal so far because of the limited number of transactions that have been completed, the potential future losses are significant. Since sale-leasebacks typically result in lower borrowing costs for municipalities, the incentive to use them instead of general obligation bonds is strong, and the potential for transferring ownership of facilities is vast. As of 1981, the net stock of state and local schools, hospitals, police and fire stations, courthouses, auditoriums, office buildings, and water supply and sewer systems was valued at nearly $2.2 trillion. Sale of even a small fraction of these assets to private parties, with a leaseback to the former nontaxable owner, would result in tax reductions far exceeding anything contemplated in current baseline revenue estimates.

Even if the subsidy is limited to new construction or rehabilitation of older buildings, the potential revenue loss is substantial. Excluding highways and streets, state and local governments accounted for about $22 billion in new construction in 1981, about 13 percent of total new construction in the economy that year.

To give an example of how the volume of sale-leaseback activity relates to the revenue loss, if sale-leasebacks amounted to $2 billion in 1984 and increased to $10 billion by 1988, the resulting revenue losses would be roughly $100 million in fiscal year 1984, rising to approximately $1.5 billion by fiscal year 1988.

Effects on the Allocation of Resources. The main limits on sale-leaseback financing are the complex nature of the transactions, which should ease as the practice becomes more widespread and familiar, and the demand for such tax shelters by high-income investors, which should be fairly strong. Sale-leasebacks would appeal to the same high-income taxpayers who invest in real estate and other tax shelters, and they might even be preferable because they are less risky. The facilities are used by state and local governments, and the degree of risk of any investment can be gauged by the credit rating of the lessee. In time, private investment in the property of nontaxable entities--which need not involve any improvements to existing facilities--could displace investment in real property, plant, and equipment for both residential and business purposes. If the nontaxable entities then turned around and invested the proceeds from the sale of their assets in taxable bonds or other high-yielding assets, some of this capital would be restored to the private sector, but in a circuitous manner. Whether the Congress wants to encourage this kind of reallocation of investment resources is an issue that should be directly addressed.

POLICY ALTERNATIVES

H.R. 3110 would deny nontaxable entities a substantial portion of the ACRS depreciation deductions by requiring that property used by them be depreciated over longer recovery periods than are now permitted under ACRS.[1] As noted earlier, this provision would, in effect, deny most or all of the subsidy portion of ACRS to nontaxable entities. These longer recovery periods would substantially weaken the incentives for private investors to buy existing property from nontaxable entities. In the case of newly constructed buildings, however, the shorter ACRS lives in existing law would continue to be allowed as long as the tax-exempt entity did not finance the property with tax-exempt bonds and as long as the lease arrangement met some standards specified in the bill.

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[1] The proposed recovery periods are 5 years for property in the 3-year class; 12 years for property in the 5-year class; 25 years for property in the 10-year class; and 35 years for property in the 15-year class.

H.R. 3110 would also tighten the restrictions on the use of the regular investment tax credit by tax-exempt entities. The special tax credits for rehabilitation of old or historic buildings would continue to be allowed for buildings used by governmental units or tax-exempt organizations, but these tax credits could not be combined with tax-exempt IRB financing. This suggests a view that, while it may be appropriate to provide a subsidy through the tax code to encourage nontaxable entities to rehabilitate older buildings, the total federal subsidy should be limited.

These measures would sharply reduce the use of sale-leaseback financing techniques. As a consequence, however, property used by nontaxable entities would receive a lower total federal subsidy than is received by comparable property used by taxable entities. As indicated earlier, if the Congress wants to provide equivalent subsidies for nontaxable entities, it could do so by providing grants or low-interest loans under existing or new programs, thereby avoiding the administrative problems and inefficiencies of using the tax system.

The approach taken by H.R. 3110 is simply to cut back on the use by tax-exempt entities of the generous tax subsidies provided by ACRS and the rehabilitation tax credits. The potential heavy use of these subsidies by nontaxable entities suggests, however, that the subsidies themselves may be unduly large in a period when federal resources are scarce. If so, reduction in these subsidies for all users might be an appropriate way of simultaneously reducing the incentives for sale-leasebacks and raising some of the revenue needed to deal with projected long-term budget deficits. If, for example, ACRS depreciation for buildings was extended from 15 to 20 years and limited to straight-line for all users, revenues would be increased by $3.8 billion in fiscal year 1986 and $7.8 billion in fiscal year 1988. If the rehabilitation tax credits were scaled back to 10 percent for buildings more than 30 years old and 15 percent for certified historic structures, revenues would be increased by $600 million in 1986 and by nearly $800 million in 1988.

TRENDS IN MUNICIPAL LEASING

Report

Prepared at the Request of
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

May 1983

Congressional Budget Office
Congress of the United States

This report was prepared by Pearl Richardson of the Tax Analysis Division, under the direction of James M. Verdier. Questions regarding the analysis may be addressed to her at 226-2680.

INTRODUCTION AND BACKGROUND

In the past few years, leasing has become an increasingly important municipal financing tool. Municipal leases take many forms and frequently substitute for tax-exempt bonds. The most common alternatives to long-term general obligation bonds are tax-exempt leases and sale-leasebacks.

Tax-exempt leases provide for the municipal purchase of property or equipment under an installment sales contract calling for periodic payments of principal and interest. The interest payments are exempt from federal taxation. Local governments use tax-exempt leases to buy all kinds of equipment, from typewriters to school buses, and, to a lesser extent, real property.

Sale-leaseback agreements make it possible for local governments and other nontaxable entities to benefit from tax deductions normally available only to the private sector. Under these agreements, a local government or a tax-exempt institution sells real property to private investors and simultaneously leases it back. The private entity puts equity into the property and in return gets rental payments and the tax benefits of ownership, which include interest deductions, depreciation deductions and, occasionally, investment tax credits. These tax benefits are generous and can be passed on to the lessee in the form of lower rental payments. Sale-leasebacks work for all manner of facilities, from college campuses to city halls, and their use is growing.

In general, the trend in municipal financing has been away from traditional general obligation bonds and toward mechanisms that make it possible to avoid seeking voter approval and to raise funds without being subject to established debt limits. The growth in the use of revenue bonds and, more recently, innovations in municipal leasing are manifestations of the search for new funding sources. So far, the growth in municipal leasing has been difficult to document with any precision. Although anecdotal information on individual projects is easy to come by, hard data on leasing activity nationwide are unavailable. As a result, it is impossible to measure the effect of municipal leasing on federal revenues. Although leasing is often a substitute for tax-exempt bond financing, it may sometimes lead to borrowing that would not otherwise occur and therefore to higher revenue losses. Since the availability of alternative financing is conjectural, increased revenue losses are very difficult to estimate.

From the standpoint of tax policy, the growing use of sale-leasebacks is a significant development. Local governments now have a much stronger incentive to sell public property to private parties than in the past. The incentives are much stronger because of the more liberal depreciation allowances and investment tax credits permitted under the Economic Recovery Tax Act of 1981 (ERTA).

The attractiveness of sale-leaseback arrangements appears to be an unintended effect of ERTA, which, in time, could have negative effects both on resource allocation and on federal revenues. At present, private entities are buying public buildings primarily to benefit from tax deductions: without the incentives in current tax law, these investments would be unlikely to occur. The costs involved in many sale-leasebacks include the federal revenues foregone from issuing tax-exempt industrial revenue bonds (IRBs) to finance property acquisition and rehabilitation, and the value of depreciation deductions and investment tax credits. In most cases, sale-leasebacks are less costly to municipalities than issuing general obligation bonds. For the federal government, however, municipal sale-leasebacks at times may be more costly, since the revenue loss from accelerated depreciation and investment tax credits may exceed that from tax-exempt bonds. Institutions without the authority to issue tax-exempt debt may also conclude sale-leaseback arrangements. In these instances, the revenue loss to the federal government is even greater, since the sale-leaseback may be taking the place of taxable rather than tax-exempt financing.

Use of Leasing by Tax-Exempt Entities

Tax incentives, such as accelerated depreciation and investment tax credits, were designed to benefit only taxable entities. Sale-leasebacks provide a way for nontaxable entities to benefit from tax incentives. The safe-harbor leasing provision, enacted in 1981 and repealed the next year, also would have extended tax incentives to nontaxable firms by allowing them, in effect, to sell tax breaks they were unable to use to firms with enough tax liability to use them. Safe-harbor leasing was intended to provide equal investment incentives to firms with different tax liabilities but similar investment opportunities. The rationale for it was that firms with sufficient tax liabilities to offset all of their credits and deductions had a comparative advantage over others because they could afford to make less productive investments than firms with little or no tax liability would be likely to make. In theory, safe-harbor leasing established a level playing field for both kinds of firms, allowing the productive value of the investment itself to determine whether it would be made. In practice, safe-harbor leasing seemed to improve the neutrality of investment incentives when used by firms that expected to be nontaxable for temporary periods and to have the opposite effect when used by firms that expected to be nontaxable for long periods.[1] An assumption underlying safe-harbor leasing was that sooner or later income from profitable investments would offset tax deductions so that tax revenues would flow back to the federal government. In the case of municipalities and tax-exempt institutions, however, the benefits that indirectly flow to them from leasing are never offset by profits and never have to be paid back. When nontaxable entities can benefit indirectly from depreciation deductions and investment tax credits, they have an advantage over taxable entities in the competition for investment resources. In permitting safe-harbor leasing of mass transit commuting vehicles for governments and public transportation authorities, the Congress clearly intended to give certain nontaxable entities such an advantage.[2] But whether the Congress intends that advantage to exist in other situations is an open issue.

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[1] Analysis of Safe-Harbor Leasing, a report prepared by the Staff of the Joint Committee on Taxation for the Committee on Ways and means, U.S. House of Representatives, and the Committee on Finance, U.S. Senate, p. 34.

The prevalent practices in municipal leasing are described in more detail below.

TYPES OF LEASING AND THEIR USES

Operating Leases

Operating (or true) leases are arrangements in which the lessee acquires use, but not ownership, of property for a term that is shorter than the asset's useful life. Lease terms are often only a year, and the property belongs to the lessor both during and upon expiration of the lease. Under current law, a nonexempt lessor must pay income taxes on the lease or rental payments. If the lessee is a governmental unit, the lessor may claim some, but not all of the benefits of ownership. Specifically, depreciation deductions are permitted, but the investment tax credit is not available unless the property involved is an old or historic building that has been substantially rehabilitated. This extension of the investment tax credit to old or historic buildings in 1981 made operating leases more attractive, although state and local governments have used operating leases for many years for a wide variety of property and equipment.

Tax-Exempt Lease-Purchase Arrangements

Growth and innovation in municipal leasing have largely been confined to tax-exempt lease-purchase arrangements and sale-leaseback agreements. In contrast to operating leases, lease-purchase agreements are essentially installment sales contracts providing for the acquisition of property by a governmental entity. Under the contract, the governmental unit makes periodic payments representing installments of the purchase price of the property plus interest. At the end of the contract term, the governmental unit will own the property or will acquire it for a nominal sum.

Tax-exempt lease-purchase agreements have to satisfy state and federal legal requirements that on the surface appear to conflict. From the standpoint of state law, the lease-purchase contract cannot constitute debt. For purposes of federal tax law, however, the contract must be an "obligation" of a governmental unit within the meaning of Section 103 of the Tax Code. Accordingly, if the contract is an obligation of a governmental unit and is structured as an installment sale, rather than as a true lease, the interest portions of the payments will be exempt from federal taxation.

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[2] Economic Recovery Tax Act of 1981, Section 201.

Since most states prohibit the obligations of a governmental unit under the lease-purchase contract from being subject to debt limitations, most tax-exempt leases have a so-called "non-appropriation" clause, which provides that the obligation of the governmental unit to continue making payments under the contract is subject to annual appropriation. This clause avoids having the agreements classified as long-term debt under state law and allows the governmental unit to terminate a lease without penalty, except for loss of the property, if the necessary funds are not appropriated. Vendors, or lessors, protect themselves from non-appropriation by charging a higher interest rate than for debt backed by the general obligation of the issuing authority and by including in the contract a clause prohibiting the governmental unit from leasing or purchasing replacement equipment for a specified time.

Uses. Tax-exempt leases have been used to acquire many kinds of equipment, from fire trucks to computers, and to a lesser but growing extent, to finance buildings and other real property. Typical transactions last from two to seven years, based on the useful life of the property, and tend to be for less than $1 million. The average lease is in the $100,000 to $200,000 range. Some recent transactions, however, have been much larger and for much longer-lived assets. These include:

- A $3.5 million police station in Los Angeles, which the city will purchase for a nominal sum at the end of the ten-year lease;
- A $34 million lease financing to fund a telephone system for San Diego County, California;
- A $54 million lease financing for new parking facilities in Anaheim, California;
- A $30 million jail and a $28.6 million school building program in Jefferson County, Colordao;
- A $23 million pier on the Columbia River for the Port of Portland, Oregon.

Financing. The financing of lease-purchase contracts depends on the size of the transaction. For smaller transactions, financing is usually provided by a single bank, insurance company, or wealthy investor. Smaller leases typically are privately placed, with a lease financing company or securities firm acting as intermediary. Larger transactions generally involve a number of investors who acquire rights to receive installment payments through certificates of participation in the lease-purchase contract. In these instances, a securities firm will underwrite a public offering or a limited placement to institutional investors. Certificates of participation, which are generally issued in units of $5,000, make it possible to market a lease financing to a large pool of investors in a manner similar to municipal bond offerings. If the offering is public, the certificates will be rated and it will be possible to trade them in secondary markets. (Ratings are usually one grade below the general obligation debt of the issuing locality, reflecting the perceived higher risk of the securities.) Privately placed, unrated leases are generally held by the lender.

Benefits and Drawbacks. For investors, leases are a source of tax-exempt income offering a higher rate of return than comparable tax-exempt obligations because of their perceived higher risk. (While purchasers of leases, or participations in them, are prohibited under federal law from taking depreciation deductions or tax credits on equipment or most kinds of property sold to local governments, they can treat the lease income as tax-exempt bond income.)

For municipalities, lease-purchase financing offers several advantages over bond financing. In addition to avoiding full cash outlay for property, it permits governmental units to finance the acquisition of capital goods without any concern about debt limits or any need to appeal to voters for approval to issue bonds. Because leases do not have the backing of the issuing authority, however, interest rates on them are higher than for general obligation bonds of similar size and term. For small transactions, the overall costs of leasing might well be lower than those of bond financing because arranging a privately-placed lease financing is less expensive than issuing bonds to the public. Moreover, lease-purchase agreements have the advantage of gearing the term of the contract to the life of the asset. In many cases, bonds are issued with maturities that far exceed the useful life of the equipment being financed. For large transactions involving certificates of participation, issuing costs are no lower than for bonds. In these instances, leasing is a means of financing capital acquisition without encumbering debt limits. It may also be a means of circumventing state interest-rate ceilings on bonded debt and of avoiding bond issuance procedures.

Volume. The volume of tax-exempt leasing is unknown. Most tax-exempt leases are privately placed, and no record of them exists beyond the local level. In the absence of federal reporting requirements, determining the volume of privately-placed tax-exempt leases would be exceedingly difficult. A few years ago, a similar problem arose with privately-placed small issue industrial revenue bonds. It turned out that enough state agencies imposed reporting requirements on local bond issuance activities to make it possible to arrive at reasonable estimates of the level of activity. So far, checks with selected state agencies have revealed that leasing is generally not subject to reporting requirements. According to Gregory Eden, Chairman of the Association for Municipal Leasing and Finance, tax-exempt leasing in 1982 amounted to about $2 billion, up from $1 billion in 1981. These estimates, which are based on known public offerings and other transactions reported by association members, are acknowledged to be rough. The volume does, however, appear to be increasing significantly.

Effects on Federal Revenues. In the absence of better estimates of the volume of net new tax-exempt leases, the costs are impossible to determine. Tax-exempt leases are not now included in the tax expenditure budget.

From the standpoint of federal revenues, tax-exempt leases are no different from tax-exempt bonds. Assuming that a project would be funded one way or another, the tax expenditure would be the same regardless of the financing mechanism. To the extent that leasing makes it possible to finance projects that otherwise would not go forward, however, tax expenditures conceivably may be higher, but by amounts impossible to determine with any confidence. In some instances, general obligation financing may be unavailable and leasing may be the only alternative. In other cases, municipalities may have alternative tax-exempt financing mechanisms.

Sale-Leasebacks

Although tax-exempt lease-purchase agreements are more prevalent, sale-leasebacks raise many more tax policy issues. Under sale-leaseback arrangements, a local government or tax-exempt institution sells public property to a private entity and simultaneously leases it back. The private entity makes an equity investment in the property and in return gets the benefits of ownership, which minimally include depreciation deductions. The local government or tax-exempt institution--such as a university, foundation, or church--gets a cash payment and an opportunity to lease back the facility at a reduced rate reflecting the owner's tax benefits. In order to meet IRS requirements, the nonprofit lessee cannot negotiate a repurchase price for the property in advance or buy the property back for less than its fair market value. The private entity must have a 20 percent minimum "at risk" investment in the project, and the lease has to generate income independent of the tax benefits.

Most sale-leaseback arrangements involve the rehabilitation of existing property or the construction of new facilities. Typically, sale-leasebacks involve at least four primary participants: a municipality, county, state, or tax-exempt organization, which owns and will subsequently lease back the property; a private equity investor; an underwriter, or lender; and a public authority, which will issue tax-exempt industrial revenue bonds to finance acquisition and construction costs.

Under ERTA, sale-leaseback arrangements have become much more attractive, largely because depreciation recovery periods are now shorter for most classes of property than they had been under previous law. In addition, ERTA also provides generous investment tax credits for the rehabilitation of buildings over 30 years old or of historic significance. With the exception of these older buildings, the investment tax credit is generally not available for assets used by governmental entities. If, however, the private entity enters into an operating lease with the owner for the provision of services, the investment may qualify for the credit. To date, these types of arrangements at the municipal or county level have been confined to sewer and solid waste disposal systems.

Uses. So far, sale-leasebacks have been used or are being considered for convention centers, educational facilities, sewer and solid waste disposal systems, wastewater treatment plants, and all manner of public buildings from libraries to museums to city halls.

Sale-leaseback transactions are generally quite complex, and although not many have actually been completed, the numbers are growing. Probably the most widely publicized deal has been the sale of the City of Oakland's Museum and Auditorium. The museum was immediately leased back to the city, and the auditorium was rehabilitated for use as a convention center extension and subsequently leased back. Total financing amounted to $22 million for the museum and $20 million for the auditorium plus the costs of renovation. The expansion of a library in Sunnyvale, California, was financed under a similar arrangement. The City of Atlanta is reportedly considering a sale-leaseback to finance the rehabilitation of its city hall. The City of Norfolk, Virginia, recently did so; debt financing came from a $3 million industrial revenue bond. Many municipalities are looking into sale-leasebacks, particularly for historic structures. So are tax-exempt non-profit institutions, particularly universities. Transactions that are now under way or have been recently completed include:[3]

- The $6.3 million Pantages Center for the Performing Arts in Tacoma, Washington, that was rehabilitated with a combination of funds from the federal government, the state, and private contributors. Federal funding included a $1.5 million grant from the Economic Development Administration. Since EDA's regulations prohibited sale or lease of the property without the permission of the Secretary of Commerce, special legislation was required to make the leaseback possible. In December 1982, the Congress passed a rider to EDA's continuing resolution permitting the lease. Over a six-year period, the performing arts center will bring the city $1.72 million in cash from the equity investors. The city will invest the funds and, beginning in the seventh year, use the earnings to defray the operating costs of the theater, which are now running at $90,000 annually, and to pay net annual lease fees of $83,000 to the purchaser. A portion of the equity investment will also be used to set up a fund for the repurchase of the building when the lease expires at the end of 35 years. The building, which dated back to 1913, was located in an urban renewal area and listed on the National Register of Historic Places. Consequently, the equity investors will benefit from a 25 percent investment tax credit. The city is now giving preliminary consideration to the leaseback of a $44 million sports and convention center.

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[3] Sources of information on these transactions include The Weekly Bond Buyer (August 16, 1982, and April 18, 1983); The Washington Post (April 20, 1983); Urban Conservation Report (April 15, 1982, October 18, 1982, March 31, 1983, and April 15, 1983); Resources in Review (November 1982); and telephone interviews with attorneys, syndicators, financial consultants, investment bankers, and local offici- officials.

- In Seattle, Washington, the Pike Place Preservation and Redevelopment Authority has arranged three leasebacks. Two were completed before the passage of ERTA. The third was a $4 million rehabilitation of an historic building, Stewart House, that was developed into a mixed-use project with retail space on the ground level and both low-income housing for the elderly and single-room occupancy units on the upper stories.
- Bennington College is arranging to lease its 650-acre campus from private investors. According to the Washington Post (April 20, 1983), the college will receive the cash necessary to pay off a $2.5 million bank loan and will be able to pay the investors back over a 20-year period.
- Towson State University in Towson, Maryland, arranged a sale-leaseback to finance the construction of new dormitories. A test case involving the sale-leaseback of a training facility for restaurant workers in Baltimore had previously established that such transactions do not violate the state prohibition against borrowing without voter approval.
- The University of Nevada is considering a sale-leaseback for two new basketball pavilions. According to the Weekly Bond Buyer (April 18, 1983), "the two pavilions could be sold for about $60 million and the university would lease them back for 55 years through a $17 million tax-exempt bond issue. The arrangement . . . would provide the university with $1.5 million in operating funds for five to seven years."
- The City of Alexandria, Virginia, is selling its Torpedo Factory arts center for $4.5 million to a limited partnership. Financing for the project will come from a $2.5 million industrial revenue bond; an equity payment of about $1.0 million from the limited partners; and a second mortgage of about $1.0 million held by the city. The city will lease back the space for sublease to local artists.
- The Southwest Sewer District of Suffolk County, New York, plans to sell its sewer system to private investors for $811 million; of that amount, about $650 million will come from the sale of industrial revenue bonds. In this case, the county will enter into an operating lease with the owners for provision of sewer services. The limited partners presumably will be able to claim both depreciation deductions and an investment credit for the property. A number of legal issues remain to be resolved before the project

can go forward. At present, the transaction is expected to be completed some time in the fall of 1983.

Benefits and Drawbacks. For private equity investors, the benefits of sale-leaseback arrangements lie primarily in the tax shelters made possible by depreciation deductions and by investment tax credits, where available. In addition, lease payments made by the municipality provide a continuous rental income stream. (The rental income is fully taxable and, as such, differs substantially from payments made under lease-purchase agreements.) If industrial revenue bonds are used to finance acquisition and rehabilitation costs, investors in them will benefit from tax-exempt income. (Under current law, the equity investors cannot hold the IRBs; if they did, the bonds would be taxable.)

For municipalities, sale-leaseback arrangements provide a means of raising funds for capital improvements that may be less costly than issuing general obligation bonds. The lower costs result from the combination of the returns on the equity payments made by the private investors and the portion of tax benefits that private investors will pass on to the municipality in the form of lower rental fees.

Sale-leasebacks usually involve lengthy negotiations. Not the least of the problems that have to be considered are arrangements for the local government to repurchase the property when the lease expires. Generally, a lease will run for between 15 and 35 years, and thereafter the local government will have options to renew it if it cannot arrive at an acceptable purchase price. The repurchase price cannot be negotiated in advance; however, since the local government will usually retain ownership of the land, it will have some flexibility at the end of the initial lease period.

Effects on Federal Revenues. The effects of sale-leasebacks on federal revenues have so far been minimal. Potentially, however, they may be a vehicle both for off-budget revenue sharing with local governments and for providing subsidies to nontaxable institutions.

Essentially, one of the effects of current tax law has been to provide incentives for nontaxable entities to give up ownership of property and productive facilities and for private entities to make investments based primarily on tax considerations. The tax losses, if any, depend on the nature of the transaction. Assuming that a municipal sale-leaseback takes the place of tax-exempt financing that would otherwise occur and that the private investors borrow funds at conventional rates, any net losses to the federal government would be limited. The savings from not issuing tax-exempt municipal bonds would largely offset the revenues forgone from the equity investors' depreciation deductions. More typically, however, sale-leasebacks involve the issuance of tax-exempt industrial revenue bonds to finance property acquisition and rehabilitation. In these instances, the tax losses are substantially greater than those resulting from general obligation financing because they include the revenues forgone from issuing IRBs, coupled with the value of depreciation deductions and, in some cases, investment tax credits. As an example, suppose a city government wished to rehabilitate its 50-year old city hall at a cost of $4 million. The city could either issue general obligation bonds or enter into a sale-leaseback agreement with a private partnership. If the private developer's acquisition and renovation costs were financed with tax-exempt IRBs, a sale-leaseback could cost the city less, and the federal government more, than rehabilitating the building with the proceeds of a general obligation bond issue. Under the sale-leaseback, the city would have to pay rent to the lessor and, 20 to 30 years later, repurchase the building at its fair market value. In the meantime, the city would benefit from the equity payment it received from the partnership, which it could invest in high-yielding securities, and from reduced rent payments, which would flow from the lessor's depreciation deductions, interest expense savings, and rehabilitation tax credits. Over a 20-year lease term, the present value of the net costs to the federal government of these benefits would be $2.6 million. By comparison, if the city floated general obligation bonds, the federal government would incur costs of about $1.1 million. Although the difference would not show up as a line item in the federal budget, the city government would nevertheless benefit from additional subsidies that effectively reduced its financing costs below the level of general obligation funding, and the private investors would benefit from generous tax writeoffs.[4]

When such nontaxable entities as universities engage in sale-leasebacks, the result may be an even greater net drain on federal revenues. These institutions often use tax-exempt debt for physical plant. But if a university sells and leases back its campus and uses the equity payment to set up an endowment or a scholarship fund, it benefits from federal subsidies for accelerated depreciation, while the federal government receives no offsetting saving from forgone tax-exempt bond financing.

Safe-Harbor Leases

Safe-harbor leasing was designed primarily for private-sector transactions. With the passage of ERTA, governmental entities have been able to take advantage of safe-harbor leasing for mass transit rolling stock vehicles financed completely or partially with tax-exempt bonds. Generally, a transit authority or local government purchases the rolling stock and sells it to a private firm. The firm, which benefits from depreciation deductions, then leases the equipment to the local government at a rate that reflects its tax savings. Several public transit authorities have negotiated such leases. In this instance, the Congress chose to extend tax benefits to transactions involving local governments and transit authorities in order to reduce the cost of public mass transit equipment. The Tax Equity and Fiscal Responsibility Act of 1982, which repealed safe-harbor leasing generally as of January 1, 1984, extended its use for mass transit vehicles until January 1, 1988.[5]

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[4] These calculations assume 20-year tax-exempt financing at 9.4 percent, an alternative taxable rate of 12.0 percent, and a discount rate of 10 percent. They also assume, for the renovated structure worth $5 million, a 20 percent rehabilitation tax credit, a full basis adjustment, 15-year straight-line depreciation for the building and improvements, and 5-year straight-line depreciation for equipment. Of the $4.2 million in depreciable property, $3.9 million is for the building and $0.3 million is for equipment. The costs to the federal government represent after-tax dollars and are offset by the net revenues generated from the rental income of the lessors, estimated at $400,000 a year for 20 years. The net rental income consists of lease payments minus interest deductions. (The city pays maintenance and operations costs.) The investors are assumed to be in the 50 percent marginal tax bracket.

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[5] Tax Equity and Fiscal Responsibility Act of 1982, Section 208.

Chairman Rostenkowski. Are there any questions?

Mr. Pickle. I want to thank you for your testimony. You have given us some good data and, I take it, it is in general support of what we are trying to do.

I am glad you pointed out that the Government tax-exempt organization currently owned nearly $2 trillion in property and if you could transfer those credits to private investors through the sale-leaseback, the amount of loss would be enormous.

You even said at one point that if you did that, it would result in tax reductions far exceeding anything contemplated in current revenue baseline estimates. That is a rather sobering, if not frightful, analysis, but I think we need to have it pointed out to us and I thank you for your testimony.

Chairman Rostenkowski. Thank you very much, Mr. Verdier.

Mr. Verdier. Thank you, Mr. Chairman.

Chairman Rostenkowski. The Chair calls Mr. Galper and Mr. Schlenger. Gentlemen, welcome to the committee. Mr. Galper, you may proceed.

STATEMENT OF HARVEY GALPER, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. Galper. My name is Harvey Galper. I am a senior fellow at the Brookings Institute here in Washington.

I should say that the views expressed here are my own and not those of my tax-exempt employer.

I am here to discuss the leasing of assets by tax-exempt entities and H.R. 3110, the Governmental Leasing Tax Act of 1983.

We have seen in recent months a wave of leasing transactions on the part of both public and private tax-exempt entities. It is entirely understandable to react to the publicity accorded to these transactions by proposing a quick legislative solution.

In addition to potential revenue losses from such leasing arrangements, there is an issue of public perception that may be at least as important.

But before measures are instituted to strike down this new alleged abuse, we should take a moment to analyze somewhat more dispassionately, I think, exactly what is going on.

Specifically, three questions should be addressed. First, what is precipitating this new movement to leasing, and, in particular, is leasing merely the symptom of some deeper defects of the tax system?

Two, what are the abuses in leasing by tax-exempt governmental and private entities that legislation should be enacted to cure?

Three, what are the appropriate policy responses in this area; that is, what goals do we hope to achieve by imposing restrictions on the tax advantages of leasing to tax-exempt entities?

Let me make clear my own views of the matter at the outset. I believe strongly that leasing is only the symptom, and more than likely not the only symptom, of serious problems in our current tax structure.

The real problem is the way we have chosen to provide incentives for investment in equipment and structures, first by the ADR system and then in 1981 by the accelerated cost recovery system enacted in the Economic Recovery Tax Act.

ACRS, in turn, is but the leading example of the tendency in recent years to enact legislation that creates a growing volume of tax-preferred, if not completely tax-exempt, real and financial assets.

Tax-exempt financial assets have been increased by permitting the issuance of tax-exempt bonds for constructing pollution control facilities, supporting individual projects by private business, making student loans, building hospitals, and financing single family mortgages in addition to traditional State and local financing.

Tax-preferred or tax-exempt real assets are created when the combined tax benefits of the investment tax credit, or other allowable credits such as those for the rehabilitation of older structures, and vastly accelerated cost recovery deductions are substantially in excess of true depreciation allowances on the capital asset.

Regardless of the kind of tax-exempt or tax-preferred asset created, they have one very significant consequence: The tax preferences are worth more to those in high tax brackets than to those in low tax brackets.

Therefore, the interaction of a graduated structure of marginal tax rates, including a zero bracket rate, with a variety of tax-preferred assets, of the kind I just described, gives the result that high bracket investors will want to hold assets carrying the greatest tax preferences and low bracket investors will prefer fully taxed assets.

We can expect the same thing to happen with tax-preferred buildings and equipment as we have seen happen with tax-exempt bonds. There will be a general sorting out process, people and institutions will tend to hold only those assets that make economic sense to them given their tax bracket.

This is the inevitable and logical result of the fact that we have chosen to provide tax incentives for investments by creating tax-preferred assets rather than by a further reduction of tax rates.

Well, what are the implications of these decisions?

First, tax-exempt entities will tend to lease rather than own assets that they require in their production processes and will only want to hold their own assets in fully taxable form.

This is at the heart of the leasing phenomenon that is of immediate concern here. It makes as little sense for a tax-exempt entity to hold a tax-preferred building as it does for them to hold a tax-exempt bond.

As the illustrative example in the appendix to this statement shows, an exempt institution can do better by leasing assets and holding fully taxable bonds instead.

Two, other low-bracket users of capital—small corporations with low tax rates, large firms incurring losses, and individual entrepreneurs with low current taxable income—will be in exactly the same situation as tax-exempt entities.

They, too, will find that leasing rather than owning is the least-cost means of acquiring the services of capital. Again, accelerated depreciation is worth more to high bracket individuals or corporations from whom low bracket enterprises can lease.

Thus, ACRS encourages leasing transactions beyond those involving tax-exempt entities.

Three, given the results in these two cases, it is difficult to even define what is meant by the term "tax-motivated leasing." The motivation that I have in mind on the part of low-bracket users of capital, is simply to acquire the services of building and equipment at the lowest possible cost.

Four, none of this discussion should be taken to mean that it is inappropriate to reduce the tax wedge on capital income in an effort to promote greater capital formation.

The overall rate of taxation of capital income is quite a separate issue. What I am criticizing here is the particular means that we have chosen to reduce taxes on capital income.

Once the decision has been made to reduce such taxes, the choice is between reducing statutory tax rates on capital income, such as cutting the corporate tax rate, or creating new kinds of tax-preferred depreciable assets, by allowing accelerated depreciation, tax credits, and other benefits.

Although the latter approach might initially be more appealing to Congress because it appears to create more investment bang for the revenue loss buck, it also has wide-ranging side effects.

Through the sorting out process just described, it generates high third-party transactions costs, inefficient owning versus leasing decisions, and widespread perceptions of unfairness in the tax system that would simply not exist with straightforward rate reductions.

The real problem then is not the availability of leasing to tax-exempt entities, but the form of the investment incentives under ACRS that makes leasing an economic decision for such entities as well as for other low-bracket taxpayers.

In focusing on the issue of leasing by tax-exempt entities, we are dealing with symptoms and not causes.

If tax-exempt institutions are doing no more than other users of capital in low marginal tax brackets, then what are the abuses in the current system?

In my view there are five possible abuse situations in leasing by tax-exempt entities, although as discussed below there may be other nonabuse policy issues also raised by such leasing.

The first possible abuse pertains to leasing in general but could conceivably emerge as a greater problem with tax-exempt institutions. This is the question of what constitutes a true lease as opposed to a mere loan from the lessor to the lessee.

Characterizing a purely financial transaction as a lease may allow income to be shifted from the lessor to the lessee by allowing the lessor to claim depreciation deductions and possibly other benefits to which he should not really be entitled.

However, since the lessee is tax exempt, additional income to the lessee is of not tax consequence although the lessor clearly benefits from taxable income lower than his economic return. It is possible that tax-exempt entities provide somewhat greater opportunities for this kind of tax avoidance than do other low bracket business firms since there is no possibility of higher tax liabilities from increasing the income flow to exempt institutions.

But the issue here, it should be emphasized, is one of determining what constitutes a true lease not whether the benefits of leasing should be made available to all.

Abusive situations where leasing itself is a sham with few, if any, burdens of ownership accruing to the nominal lessor should be disallowed whenever they occur.

A second possible abuse situation by tax-exempt institutions occurs when these institutions are able to combine several different tax benefits to obtain a lower cost of capital than is generally available to other capital users.

Particularly at issue here is the use of tax-exempt bond financing by State and local governments, or by other parties through the intermediation of State and local governments, in addition to accelerated depreciation and possible rehabilitation credits.

The cumulative effect of such tax benefits can go far beyond the reduced costs of capital available just from leasing.

A third possible abuse is the ability of tax-exempt institutions to realize arbitrage profits on their existing assets, primarily structures, through sale-leaseback, or possibly lease-leaseback transactions.

A fourth abuse occurs when the Federal Government leases property from private lessors who can then claim the tax benefits of ACRS. There should be no illusions here.

The Federal Government cannot subsidize itself; it can only subvert sound budgetary procedures by not taking account of the full costs of its procurement actions.

Finally, although I have little to say in this area, there may be abuses from allowing lessors to claim tax benefits on assets leased to foreign users of capital.

What, then, are the appropriate policy responses to leasing by tax-exempt entities?

As we all know, the road we take depends upon where we want to go. At the broadest level, the problem we are encountering results not from the availability of leasing, per se, but as a consequence of the particular incentives provided to stimulate capital investment—ACRS, tax credits, and the like.

These tax provisions have created opportunities for a range of tax sheltered transactions far beyond leasing to tax-exempt entities. If the concern is to deal with the question of tax shelters, why are transactions involving tax-exempt entities so much more objectionable than any others?

All users of capital that, through the grace of the Tax Code, find themselves with zero or near zero marginal tax rates have the same incentive to lease rather than own.

Should their opportunities to lease assets be similarly restricted? The obvious solution is not creating the tax shelters in the first place.

The broad solution is to avoid the creation of tax-preferred assets by taxing the income from all assets uniformly.

Failing such comprehensive approaches, we have to ask what kind of second best arrangements might make the most sense, and here it is necessary to clarify the exact purpose of the tax incentives.

If the tax benefits of ACRS and various tax credits are to stimulate greater capital intensity, why is greater capital intensity in the capital tax-exempt sector also not desired?

My general inclination would be to allow leasing on the same terms as allowed to other low-bracket users of capital except where there are genuine abuse situations as outlined earlier.

How do we deal with the abuse situations? I think that H.R. 3110 deals effectively with many of these abuse situations.

First, with respect to determining what constitutes a real lease H.R. 3110 appropriately denies ACRS deductions where the transaction seems to be more of a sale than a lease.

Second, H.R. 3110 correctly, in my view, prevents the combined use of tax-exempt financing of ACRS deductions and the combined use of rehabilitation credits and tax-exempt financing.

Third, H.R. 3110 prevents tax-exempt entities from earning arbitrage profits under existing structures, a very desirable restriction.

There are, however, some respects in which H.R. 3110 may require modification. First, as I read the bill the definition of what constitutes tax-exempt use property, with the consequent loss of tax benefits to the lessor, appear considerably more stringent in the case of personal property than real property.

Second, the rules for computing depreciation deductions in the event that ACRS benefits are lost appear to impose greater penalties for personal than for real property.

Thirty-five year straightline depreciation without regard to salvage value is less disadvantageous for buildings than is 12-year straightline for equipment such as computers and word processors and photocopiers.

Third, the abuse in leasing by the Federal Government is simply ignored in H.R. 3110. In this case no deductions in excess of our best estimates of true depreciation should ever be allowed to lessors who rent property to the Government.

Since the Federal Government cannot subsidize itself, we have to make sure that the Federal Government pays the full, unsubsidized market rates and budgets properly for all the costs—direct outlays and tax subsidies—of its procurement programs.

The only way to make sure that this occurs is to deny to lessors any of the tax benefits.

Beyond these abuses, I have no problem with the availability of tax benefits for leasing by low bracket and other tax-exempt users of capital. However, the next time people talk of the virtues of accelerated depreciation as an investment incentive I would urge the committee to remember both the undesirable side effects that we are grappling with today and others that may become revealed to us only in the fullness of time.

Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Galper.

[The prepared statement follows:]

STATEMENT OF HARVEY GALPER, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. Chairman and Members of this Committee: My name is Harvey Galper. I am a Senior Fellow at the Brookings Institution here in Washington. I should also say that the views expressed here are my own and not those of my tax-exempt employer. I am pleased to be here today to discuss the leasing of assets by tax-exempt entities and H.R. 3110, the Governmental Leasing Tax Act of 1983.

GENERAL DISCUSSION

We have seen in recent months a wave of leasing transactions on the part of both public and private tax-exempt entities, from the sale and leaseback of municipal facilities by the City of Oakland, California to a similar transaction with respect to its campus by Bennington College.[1] It is entirely understandable to react to the publicity accorded to these transactions by proposing a quick legislative solution to what appears to be another rip-off of the U.S. tax system. After all, why should entities that would pay no taxes on the return to physical assets if they were owned outright be allowed to rent them instead from other parties, thereby allowing the nominal owners to claim accelerated depreciation and various tax credits? In addition to potential revenue losses from such leasing arrangements, there is an issue of public perception that may be at least as important. The impression is clearly created that any way to reduce taxes is fair game; you just have to look at what our finest educational institutions are doing. As was the case with safe-harbor leasing, leasing by tax-exempt institutions is getting the same bad press and is leaving taxpayers with the same uneasy feeling.

The deterioration of public confidence in the tax system is indeed a serious cause for concern, but before measures are instituted to strike down this new alleged abuse, we should take a moment to analyze somewhat more dispassionately exactly what is going on. Specifically, three questions should be addressed:

1. What is precipitating this new movement to leasing, and, in particular, is leasing merely the symptom of some deeper defects of the tax system?
2. What are the abuses in leasing by tax-exempt governmental and private entities that legislation should be enacted to cure?
3. What are the appropriate policy responses in this area; that is, what goals do we hope to achieve by imposing restrictions on the tax advantages of leasing to tax-exempt entities?

I shall address each of these questions in turn.

LEASING: THE SYMPTOM NOT THE CAUSE

Let me make clear my own views of the matter at the outset. I believe strongly that leasing is only the symptom, and more than likely not the only symptom, of serious problems in our current tax structure. The real problem is the way we have chosen to provide incentives for investment in equipment and structures, first by the Asset Depreciation Range (ADR) system and then in 1981 by the Accelerated Cost Recovery System (ACRS) enacted in the Economic Recovery Tax Act. And ACRS in turn is but the leading example of the tendency in recent years to enact legislation that creates a growing volume of tax-preferred, if not completely tax-exempt, real and financial assets.

Tax-exempt financial assets have been increased by permitting the issuance of tax-exempt bonds for constructing pollution control facilities, supporting individual projects by private business, making student loans, building hospitals, and financing single family mortgages in addition to traditional state and local financing. Tax-preferred or tax-exempt real assets are created when the combined tax benefits of the investment tax credit (or other allowable credits such as those for the rehabilitation of older structures) and vastly accelerated cost recovery deductions are substantially in excess of true depreciation allowances on the capital asset.

Regardless of the kind of tax-exempt or tax-preferred asset created, they have one very significant consequence: the tax preferences are worth more to those in high tax brackets than to those in low tax brackets. Therefore, the interaction of a graduated structure of marginal tax rates (including a zero bracket rate) with a variety of tax-preferred assets gives the result that high bracket investors will want to hold assets carrying the greatest tax preferences and low bracket investors will prefer fully taxed assets. We can expect the same thing to happen with tax-preferred buildings and equipment as we have seen happen with tax-exempt bonds. There will be a general sorting out process: people and institutions will tend to hold only those assets that make economic sense to them given their tax bracket.

Low bracket, or tax exempt institutions that do not find tax-exempt bonds an economic investment will also not want to hold tax-exempt or tax-preferred buildings in their portfolios. The tax benefits from these latter depreciable assets will tend to end up in the hands of those to whom they are most valuable. This is the inevitable and logical result of the fact that we have chosen to provide tax incentives for investment by creating tax-exempt or tax-preferred assets rather than by a further reduction of tax rates.

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[1] For a description of these and other related transactions, see Congressional Budget Office "Trends in Municipal Leasing," May 1983.

Several implications of the decision to structure tax incentives for investment through accelerated depreciation and similar devices, should be noted.

(1) Tax-exempt entities will tend to lease rather than own assets that they require in their production process and will only want to hold their own assets in fully taxable form. This is at the heart of the leasing phenomenon that is of immediate concern here. It makes as little sense for a tax-exempt entity to hold a tax-preferred building as it does for them to hold a tax-exempt bond. As the illustrative example in the Appendix to this statement shows, an exempt institution can do better by leasing assets and holding fully taxable bonds instead.

(2) Other low-bracket users of capital—small corporations with low tax rates, large firms incurring losses, and individual entrepreneurs with low current taxable income—will be in exactly the same situation as tax-exempt entities. They, too, will find that leasing rather than owning is the least-cost means of acquiring the services of capital. Again, accelerated depreciation is worth more to high bracket individuals or corporations from whom low bracket enterprises can lease. Thus, ACRS encourages leasing transactions beyond those involving tax-exempt entities.

(3) Given the results in these two cases, it is difficult to even define what is meant by the term "tax-motivated leasing." The motivation that I have in mind on the part of low-bracket users of capital, is simply to acquire the services of building and equipment at the lowest possible cost.

(4) None of this discussion should be taken to mean that it is inappropriate to reduce the tax wedge on capital income in an effort to promote greater capital formation. The overall rate of taxation of capital income is quite a separate issue. What I am criticizing here is the particular means that we have chosen to reduce taxes on capital income. Once the decisions has been to reduce such taxes, the choice is between reducing statutory tax rates on capital income (such as cutting the corporate tax rate) or creating new kind of tax-preferred depreciable assets (by allowing accelerated depreciation, tax credits, and other benefits). Although the latter approach may initially be more appealing to Congress because it appears to create more investment bang for the revenue loss buck, it also has wide-ranging side effects. Through the sorting out process just described, it generates high-party transactions costs, inefficient owning versus leasing decisions, and widespread perceptions of unfairness in the tax system that would simply not exist with straightforward rate reductions.

The real problem then, is not availability of leasing to tax-exempt entities but the form of the investment incentives under ACRS that makes leasing an economic decision for such entities as well as for other low-bracket taxpayers. In focusing on the issue of leasing by tax-exempt entities we are dealing with symptoms and not causes.

ABUSES IN LEASING BY TAX-EXEMPT ENTITIES

If tax-exempt institutions are doing no more than other users of capital in low marginal tax brackets, then what are the abuses in the current system? In my view there are five possible abuse situations in leasing by tax-exempt entities (although as discussed below there may be other non-abuse policy issues also raised by such leasing).

The first possible abuse pertains to leasing in general but could conceivably emerge as a greater problem with the tax-exempt institutions. This is the question of what constitutes a true lease as opposed to a mere loan from the "lessor" to the "lessee". Characterizing a purely financial transaction as a lease may allow income to be shifted from the "lessor" to the "lessee" by allowing "lessor" to claim depreciation deductions and possibly other benefits to which he would not really be entitled. However, since the "lessee" is tax-exempt, additional income to the "lessee" is of no tax consequence although the "lessor" clearly benefits from taxable income lower than his economic return. It is possible that tax-exempt entities provide somewhat greater opportunities for this kind of tax avoidance than do other low bracket business firms since there is no possibility of higher tax liabilities from increasing the income flow to exempt institutions. But the issue here, it should be emphasized, is one of determining what constitutes a true lease not whether the benefits of leasing should be made available to all. Abusive situations where leasing itself is a sham with few if any burdens of ownership accruing to the nominal lessor should be disallowed whenever they occur.[2]

A second possible abuse situation by tax-exempt institutions occurs when these institutions are able to combine several different tax benefits to obtain a lower cost of capital than is generally available to other capital users. Particularly at issue here is the use of tax-exempt bond financing by state and local governments (or by other parties through the intermediation of state and local governments) in addition to accelerated depreciation and possible rehabilitation credits. The cumulative effect of such tax benefits can go far beyond the reduced costs of capital available just from leasing.

A third possible abuse is the ability of tax-exempt institutions to realize arbitrage profits on their *existing* assets, primarily structures, through sale-leaseback (or possibly lease-leaseback) transactions. Transactions with existing assets are to be sharply distinguished from leasing new assets as a means of reducing the cost of acquiring the services of additional capital. The possible abuse with respect to existing property is that tax-exempt entities can enjoy a pure windfall by selling currently owned structures, investing the proceeds from the sale in fully taxed bonds, and thereby generating sufficient revenues to cover the rental costs on the property and still have something left over. Structures that are sold and leased back in this fashion are subject to anti-churning rules, and thus lessors cannot claim full ACRS deductions (15 year recovery periods and accelerated methods). Nonetheless, longer write-off periods for buildings (25 years or more) and straightline depreciation can still provide a partially exempt return that is worth more to high tax than to tax-exempt entities. Deals put together on this basis still work.

A fourth abuse occurs when the federal government leases property from private lessors who can then claim the tax benefits of ACRS. There should be no illusions here. The federal government cannot subsidize itself; it can only subvert sound budgetary procedures by not taking account of the full costs of its procurement actions.

Finally, although I have little to say in this area, there may be abuses from allowing lessors to claim tax benefits on assets leased to foreign users of capital.

POLICY RESPONSES

What then are the appropriate policy responses to leasing by tax-exempt entities? As we all know, the road we take depends upon where we want to go. At the broadest level, the problem we are encountering results not from the availability of leasing per se but as a consequence of the particular incentives provided to stimulate capital investment—ACRS, tax credits, and the like. These tax provisions have created opportunities for a range of tax sheltered transactions far beyond leasing to tax-exempt entities. If the concern is to deal with the question of tax shelters, why are transactions involving tax-exempt entities so much more objectionable than any others? All users of capital that, through the grace of the tax code, find themselves with zero or near zero marginal tax rates have the same incentive to lease rather than own. Should their opportunities to lease assets be similarly restricted?

In fact, if tax shelters are of such concern we should not have provided tax incentives in the form of accelerated depreciation in the first place. The broad solution to the tax shelter problem is to avoid the creation of tax-preferred assets by taxing the income from all property uniformly. In that event, all users of capital, whatever their bracket, would find tax considerations of no consequence in choosing between owning and leasing. In contrast, under current law, there may be substantial differences among the various leasing arrangements with tax-exempt entities with respect to the importance of tax considerations. Short-term equipment leases to exempt entities where the investment tax credit is not available may generate few tax benefits, whereas longer-term leases on structures and generate substantial tax benefits.

There are two ways to eliminate the differential taxation across assets occurring under current law. The first approach is to restore proper income measurement rules, do away with special credits and the like, and then, set much lower statutory rates to hit our revenue targets. Reduced tax wedges in order to stimulate saving and investment would then result from low tax rates rather than reductions in taxable income relative to economic income. The second approach to uniformity is the consumption tax approach that would exempt all capital income from tax across the board. Again, assets would all be taxed alike and there would be no tax reason for preferring leasing to direct ownership.

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[2] Safe harbor leasing, which is strictly a means of transferring tax benefits across parties, does not generally apply to exempt entities with the exception of mass commuting vehicles.

Failing such comprehensive approaches, we then have to ask what kind of second best arrangements might make the most sense, and here it is necessary to clarify the exact purpose of the tax incentives. If the tax benefits of ACRS and various tax credits are intended to stimulate greater capital intensity, why is greater capital intensity in the tax-exempt sector also not desirable? Do we only wish to encourage office automation and new production techniques in taxable enterprises? Should tax-exempt entities have to incur higher capital costs in those specific situations where they genuinely have no choice except to rent—office space, computers, etc? We clearly need to establish exactly where we want more capital and what kind of incentives are appropriate. My general preference would be to allow leasing by tax-exempt entities on the same terms as allowed to other low-bracket users of capital except where there are genuine abuse situations, as outlined earlier.

Real abuse cases should then be dealt with along the lines proposed in H.R. 3110. First, with respect to determining what constitutes a real lease, H.R. 3110 appropriately denies ACRS deductions for real property where the transaction seems to be more of a sale than a lease. Second, H.R. 3110, correctly in my view, prevents the combined use of tax-exempt financing and ACRS deductions for real property and the combined use of rehabilitation credits and tax-exempt financing. Third, H.R. 3110 prevents tax-exempt entities from earning arbitrage profits on their existing structures. This is a desirable restriction that is very much in the spirit of both the anti-churning rules enacted under ERTA and the anti-arbitrage rules that disallow tax-exemption on state and local bonds issued for the purpose of investing the proceeds in taxable securities. If tax-exempt bonds cannot be issued to earn taxable securities. If tax-exempt bonds cannot be issued to earn taxable yields, then the sale of partially taxed buildings should be disallowed on the same grounds. Possible abuse situations in the foreign area which I have not addressed are also dealt with by the proposed legislation.

There are, however, some respects in which H.R. 3110 may require modification. First, the definitions of what constitutes "tax-exempt use property," with the consequent loss of tax benefits to the lessor, appear considerably more stringent in the case of personal property than real property. For real property, "tax-exempt use property" is defined to include only property financed by tax-exempt bonds, existing assets sold and leased back, and transactions involving sham leases. "Tax-exempt use property" for personal property is much more broadly defined.

Second, the rules for computing depreciation deductions in the event that ACRS benefits are lost appear to impose greater penalties for personal than for real property. Thirty-five year straight line depreciation without regard to salvage value is less disadvantageous for buildings than is twelve year straight line for equipment such as computers or word processors.

Third, the abuse in leasing by the federal government is simply ignored in H.R. 3110. In this case, no tax deductions in excess of our best estimates of true depreciation should ever be allowed to lessors who rent property to the federal government even under a true lease. This will insure that the federal government pays full unsubsidized market rents and budgets properly for all the costs—direct outlays and tax subsidies—of its procurement programs. (Some allowance would have to be made, however, for casual leases.)

Beyond these abuses, I have no problem with the availability of tax benefits for leasing by low-bracket and tax-exempt users of capital. However, the next time people talk of the virtues of accelerated depreciation as an investment incentive, I would urge the Committee to remember both the undesirable side-effects that we are grappling with today and others that may only become revealed to us in the fullness of time.

Appendix

Table 1. Illustration of Advantages of Leasing for Tax-Exempt Entities

Assumptions

Fully taxable yield = 13%
Before-tax return on structures = 11%
Market value of buildings = $20 million
Marginal tax rate of lessor = 50%
Return on structures is 70% taxable

Case I: Tax-exempt entity owns buildings and potential lessor holds taxable bonds

	Tax-exempt entity	Potential lessor
Assets	$20 million	$20 million
Before-tax cash return	0	$2,600,000
Tax	0	1,300,000
After-tax cash return	0	1,300,000
Rental payments	0	—
Net cash flow	0	1,300,000

Case II: Tax-exempt entity holds taxable bonds and rents buildings from lessor (both gain).

	Tax-exempt entity	Lessor
Assets	$20 million	$20 million
Before-tax cash return	2,600,000	$2,200,000
Tax	0	770,000
After-tax cash return	2,600,000	1,430,000
Rental payments	2,200,000	—
Net cash flow	400,000	1,430,000

Chairman **Rostenkowski**. Mr. Schlenger, you may proceed.

STATEMENT OF JACQUES T. SCHLENGER, PARTNER, VENABLE, BAETJER & HOWARD, BALTIMORE, MD.

Mr. **Schlenger**. Thank you. I have been asked to take you through the mechanics of how these work.

I don't know if I have done as many as anyone in the country, but I was one of the first.

If you would be interested at the end where you can read it on the first page of my statement are good reasons, I think, why sale-leasebacks are not indefensible, but a very good thing indeed, and I am authorized by the city of Baltimore as well as other groups to say that there is a major source of revenue that you would be cutting off if this bill is passed.

That may be a desirable thing, but it shifts from the grassroots governmental level to Washington. It has that effect.

I will come back to that, if I may. The peculiarities of the tax law, as you know, generally prefer sale-leasebacks of real property to personal property.

If you look at page 2 of my statement, typically there is what we call in Maryland a ground lease for 40 or 50 years. The tax-exempt user, the city or State or other tax-exempt entities, lease the land to the investor partnership and the rent is only adjusted every 5 years for inflation and at the end of the ground lease, the lease terminates and the improvements, that is the building on it and everything on it, reverts, returns to the ownership of the institution. The limited partnership then buys the improvements of the existing building or it constructs the improvements.

The money comes from two sources, money that the investors put up and to give you a practical dimension, if it is a $10 million building, the municipality would generally get 20 or 25 percent.

That is the discounted market value of the tax advantages. The balance is generally financed by tax-free bonds and that may be a separate evil, but at least it is separate.

The other way of financing is for the selling municipality to take back purchase money financing, the way everybody else has been doing it.

I wrote a book on sale-leaseback, I think, 30 years ago in the commerce sense, so this is not un-American. It is not new.

President Eisenhower arranged for leases in most of the post offices and many of my clients still own them, and I don't think the Federal Government has collapsed because of that.

The newest twist on this is a so-called lease and leaseback where the municipality or the college or whatever leases the property. That is the real property as well as the land instead of selling it and leasing it back.

This is more attenuated arguably as is the take-back of a purchase money market than third party financing, meaning bonds or a bank lending, and perhaps more risky.

Typically, the bonds will have a 25-year life or thereabouts. They will be secured by a leaseback from the investors to the tax-exempt entity, such as Baltimore City, the State of Maryland, New York

Port Authority, and the rent will be the security, really, for the borrowing as it is in any commercial transaction.

It's a so-called net, net, net lease. Anybody who wants to know what a triple net lease is, I can give you a technical definition, but I guess with lawyers, one word will never suffice when three can be used.

The investors generally put the money in over 5 or 6 years. They stagger this because, first, they don't like to put their money up any faster than they have to. Second, it affects the tax deductions.

The leaseback generally has a rent and the rent is summarized at the bottom of page 4, and the rents are almost always the same unless the "pig" theory applies and I will come to that.

The rent would consist of the rent under the ground lease. In other words, if the city rents the ground for $1,000 a year, the investor will pay $1,000 back to cover that and get that money back.

The city or municipality would also pay the debt service. If it costs $50,000 a year to amortize the IDB's, then the rent has $50,000 added to it.

Then there is a profit on the amount the investors put up, 3 to 5 percent. This is reality.

It is a real cash return. Some of the investors oppose this on the theory that they would not like to put the cash up and, therefore, it is more risky.

An alternative to this, instead of having the investors put the money up as a purchase part of the purchase price, is for the investing partnership to pay less rent the first 5 or 6 years.

It has the same economic effect. It is called rent abatement.

The necessity of the profit factor on the investment and the gap, remember the ground lease is for 40 years, so the building does not revert for 40, but the leaseback by the investment partnership to the tax-exempt entity is for 30. That is called the "gap" and tax lawyers have strange vocabularies, but the gap here means that the investors are at risk because suppose the lease expires.

The city does not have to release it and contrary-wise, the investors don't have to release it to the city. They could take as owners in fee or subject to the ground lease of the building and vacate the building. They can tear it down, any number of things.

The sale-leaseback issue, the tax issue, principally, is one of ownership by the investors because that triggers the tax advantages of depreciation and if applicable, and generally they are not, investment credit.

This has been sanctioned by the Supreme Court after oodles of litigation and I really doubt that it is wise in this bill, I have questions about the entire bill, to reopen something that has been judiciously handled, I think, quite well.

The exempt organization is normally worried about getting its building back. There is an emotional factor here more than a real factor. So normally at the end of the 30-year lease the municipality has the option to buy the improvements back from the owner/lessor for fair market value, that is a risk factor.

No. 2, they could release it. That is another security blanket.

No. 3, they could condemn the improvements and pay fair value, and No. 4 is the lease, leaseback which I think signifies and personifies this reluctance.

The ground rent payable by the lessor has to be paid during the 10-year gap and that is another reason to negotiate. What I predict will happen in most of these arrangements is that after 10 or 15 years of a 30-year leaseback, the partnership will probably give the building back or arrange to convey it back or sell it back at a reduced cost because they have gotten most of their tax advantages, so it is not a great benefit.

Now, one of the things I think significantly omitted in prior discussions, there may be $2 trillion of buildings out there for sale, but no government, local government in its right mind is going to sell $2 trillion worth.

There are not that many high bracket taxpayers. I think they are being eliminated faster than the market.

No. 2, if you look at the economics, if the city of New York sells a building and then leases it back, that is a constant charge, that rent it has to pay for 30 years or whatever the term of the lease, so they are encumbering, to an extent, the future and the economic reason, and there are good economic reasons here, is that the city, say, in that situation, believes that the 20 or 25 percent of the value it receives from the investors will be money that it can spend for legitimate government needs upfront, capital needs.

Obviously, if that money is used for operating purposes, they are liquidating their investments, which is obviously not a good thing.

There are all sorts of legal things involved here, one of which is that a bona fide lease by the municipality or is it a debt?

Our firm took that case to the Maryland Court of Appeals. I think it is the first modern case in the area and the Maryland lower court and the Maryland Court of Appeals by a 5-to-2 decision said that a lease is a lease is a lease, and the dissenting judge in a Rube Goldberg cartoon opinion illustrated with a graph said that a debt is a debt is a debt.

So the law in Maryland is that a bona fide sale-leaseback will not be treated as a debt. The reason for this problem is that in most States and localities, in order to borrow money, you must have recourse to the voters and the question was whether there was a way around it.

I would also like to say that there is not a real practical problem, it seems to me, that the bill deals with so far as used real property because since the anti-churning rules apply, you are going to have an effective, useful life for depreciation there that is not 15 years, but it is closer to 30 years and, therefore, extending it to 35 is no big deal.

Where this really hurts or applies, it seems to me, is principally to new construction and there ACRS would apply and it is difficult to imagine why it is good policy to curb that in these times when local governments are pressed and jobs are scarce and that would be the effect of cutting this off, I would think.

Now, if one wanted to deal in a rational and, I think, a fair way, with what may be a problem, that is the abuse by a tax-exempt organization of what I call inchoate tax advantages inherent in ownership, then one would not adopt this bill.

I think it has major drafting problems, but conceptually I think it is bad because the evil-doer would be the tax-exempt organization and what you should do is impose a penalty tax like unrelated income or some such thing on the tax exempt entity or deny its exemption in whole or in part.

Now, that may have political ramifications, but to me it makes no sense for, say, the lessor/investor to be treated differently in a tax sense when he, she, it or they leases to a profitmaking hospital as opposed to a non-profitmaking hospital.

Now, the sponsors also allege, and some of the speakers today, that the occupancy costs, the costs of this, Mr. Chapoton said this, are higher under a sale-leaseback. I dispute that at the State and local level.

I cannot address the vagaries of Federal practice and procurement, but at the local level and at the State level, very astute financial people in the Government believe it is cheaper to do it through sale-leaseback, not only in terms of effective interest rates, because if you take the 20 or 25 percent paid upfront and add it with the IDB and balance that against general obligation bonds, the interest rates are about the same.

The big saving is having capital money to beat inflation, to build it right now and that can be the great advantage. The other advantage is, and I have seen this happen, when a private entrepreneur in one case builds dormitories for a college, the cost will be about 25 percent lower, and it will be exactly on time, than if the Government had done it.

The most insidious aspect of this, I think, is the trend of the effective date of this bill, May 23. You have heard prior testimony.

I urge you to issue a statement that the effective date has not been decided upon, at the request of the city of Baltimore, a large group in Jacksonville that is putting up a convention center and around the country. It takes sometimes a year or two to negotiate such an arrangement.

Tremendous amounts of money have been expended. Some Government approvals have been obtained and this shows it.

It is tantamount to legislation by a small group or one person. That is the effect. It seems to me that it would be far fairer—and it is not in the interest of the Government to act unfairly to hit a few tax miscreants, and they are—to say that the effective date is open and it will be prospective.

What that would do is allow the completion of present deals and I can assure you there would be a freeze of prospective deals, however dubiously, and I don't think that then you would be doing violence to the principles of fairness.

The last thing I would urge, and then I want to thank you very much for having heard me, is that I think the bill is unnecessary as a practical matter and a philosophical matter.

This reminds me of safe harbor leasing and some of the other reforms that have been proposed here. In each and every case, the proponents and technicians in your committee and in the Government have been wrong, including the ABA people, because they have made the law more complicated, cumulatively less understandable, and less predictable and it is a game and it is a terrible thing to do.

It seems to me that this type of device, the sale-leaseback, will probably have many abuses and under the rule that cheap money drives out good money, that any goodness in the device will quickly be exhausted by the promoters and users, the pig theory, and inevitably this will occur and the courts and the IRS are better equipped than this committee by legislation, as to which it really can't understand the impact, trying to deal with an administrative problem.

Mr. Chairman, I thank you and I would answer any questions people may have on how these things operate in practice.

Chairman ROSTENKOWSKI. Thank you, Mr. Schlenger.

[The prepared statement follows:]

STATEMENT OF JACQUES T. SCHLENGER, PARTNER, VENABLE, BAETJER & HOWARD, BALTIMORE, MD.

I. Introduction.

A. Sale and leaseback transactions are being increasingly explored and used by municipalities, states and other tax-exempt organizations as a means of "realizing" the tax and other benefits inherent in the ownership of depreciable property. The "payments" for such benefits represent a significant potential source of revenues for municipalities, states and other tax-exempt organizations.

B. Sale and leaseback transactions provide an opportunity for "off balance sheet"* financing, thereby reducing the drain on the municipality's borrowing capacity.

C. Sale and leaseback transactions, because they typically involve fewer regulatory approvals than do traditional borrowings, can often be used to cut through "red tape."

D. Where new construction is involved, sale and leaseback transactions can reduce costs by allowing for shorter construction periods, more efficient procurement, and more attention to costs and economics by the private developer-owner-lessor.

E. In certain instances, sale and leaseback transactions can be useful in adding properties to the tax rolls.

F. The new construction or rehabilitation financed by sale and leaseback transactions contributes to employment, economic activity and governmental control at the "grass roots" level, rather than through Washington-controlled programs.

II. Basic structure of a typical sale and leaseback transaction.

A. Because of tax peculiarities (unavailability of investment tax credits ("ITC") if leased to tax-exempt organization or governmental unit and no requirement that investors be "at risk"), most sale and leaseback transactions involve primarily real (as opposed to personal) property.

B. A municipality will typically lease the land underlying an existing improvement (or an improvement to be constructed) to an investor or limited partnership for a term of 40 to 50 years.

1. The ground lease will typically provide for the payment of a fair market rental with an inflation adjustment every 5 years or so.
2. At the expiration of the ground lease, any improvements will revert to the municipality.

C. The limited partnership will, following the ground lease, then acquire the existing improvements (or arrange for the construction of the new improvements) from the municipality.

1. The financing for the acquisition (or construction) will typically come from two sources: an issue of tax-exempt industrial development bonds ("IDB's") under Section 103* and contributions from limited partner/investors (amounts may be taken back as purchase-money financing by the municipality or a lease and leaseback of a facility may be structured, both possibly more attenuated and risky on the tax point of ownership by the investor). Note: A series of extremely intricate rules govern the availability of IDB's, and their availability in any given situation cannot be assumed. No exempt "small issue" IDB's may be issued after December 31, 1986. See Section 103(b)(6)(N).

2. The IDB's will typically have a term of 25 to 30 years. Because, as discussed below, the IDB's will be secured by a "triple net" ground and building lease with the municipality or state, the interest rate on the IDB's should normally

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*/ All Section references herein are to the Internal Revenue Code of 1954, as amended.

not be significantly greater than the municipality's or state's borrowing rate. When the cash payment or payments made by the purchaser-investor to the tax-exempt seller-user are taken into account, the effective interest rate is generally less than the governmental unit's normal borrowing rate.

3. The payments from the investors will typically be made over a 5 to 6 year period in approximately equal installments.

D. The land and improvements will then be leased back by the limited partnership to the municipality, state or tax-exempt organization.

   1. The ground and building lease will typically have a term equal to the term of the IDB's (i.e., 25 to 30 years).

   2. The rental under the ground and building lease will be equal to the sum of the following: (i) the rental under the ground lease; (ii) the debt service on the IDB's; and (iii) a profit factor equal to 3% to 5% of the investor payments (a current, cash return on cash invested). Note: All or a portion of the investor payments could be used to reduce the rental payments due from the municipality, state or tax-exempt organization under the ground and building lease over

the first 5 or 6 years (called "rent abatement"), as opposed to being used to make payments of purchase price, as discussed above.

3. The ground and building lease is a "triple net" lease pursuant to which the municipality, state or tax-exempt organization is responsible for all taxes, insurance, and repair and maintenance expenses.
4. Both the profit factor and the "gap" between the term of the ground lease and the term of the ground and building lease are considered necessary to make the purchaser-lessor the owner and give the transaction substance for federal income tax purposes. See U.S. v. Frank Lyon Co., 435 U.S. 561 (1978).
5. The interests of the municipality, state or other tax-exempt organization during the "gap" period are typically protected by the following:
    - (i) The municipality, state or tax-exempt organization can be given an option to acquire the improvements at the expiration of the ground and building lease at their fair market value.
    - (ii) The municipality, state or tax-exempt organization can re-lease the improvements at fair current rent during the "gap" period.

(iii) The municipality or state may be able to condemn the improvements.

(iv) One apparent reason for the new wrinkle of a lease-leaseback is the apparent reluctance of the municipality, state or tax-exempt organization to part with legal ownership, economic realities notwithstanding.

(v) The substantial ground rental payable by the owner-lessor partnership during the "gap" period provides substantial "negotiating leverage."

(vi) The owner-lessor limited partnership will have an incentive to dispose of the improvements after the tax benefits are exhausted (i.e., after 10 to 15 years). Under the "Accelerated Cost Recovery System" ("ACRS") of Section 168, the cost of real property (other than land) may be recovered over a period of 15 years. ACRS does not apply to property owned and used by a municipality, state or tax-exempt organization before 1981.

E. The IDB's are secured by an assignment of the ground and building lease and by a mortgage of the improvements. Because of the assignment of the ground and building lease, the interest rate on the IDB's will tend to approximate the municipality's or state's borrowing rate.

III. A few "rules of thumb."

A. Because of the "at risk" rules, real (as opposed to personal) property is generally a more attractive candidate for a sale and leaseback. Section 465(c)(3)(D) provides an exception to the at risk rules for the "holding of real property."

B. Because "ACRS" is generally not available with respect to property first "placed in service" prior to 1981 which is sold and leased back (See Section 168(e)(4)), new construction or property first "placed in service" after 1980 will generally be a better candidate for a sale and leaseback transaction.

C. Investment tax credits generally are not available with respect to property leased to a municipality or state. See Section 48(a)(5). An important exception exists with respect to "rehabilitations." An ITC will generally be available for rehabilitation expenditures even if such structures are leased to a municipality or state. Because of the value of the ITC's to investors, projects involving rehabilitation are prime candidates for sale and leaseback transactions.

IV. Legal and tax issues.

A. Sale and leaseback transactions involve a number of very complex legal and tax issues which need to be carefully considered by counsel.

B. Among the more significant legal issues are the following:

1. Will the sale and leaseback constitute a "borrowing" under the municipality's or state's charter or constitution? If debt, there may be a requirement of voter approval or a debt limitation.

2. Is the sale and leaseback of the municipality's or state's property permitted under its charter or constitution?

3. Will the ground and building lease (the primary security for the IDB's) be enforceable in accordance with its terms?

C. The primary tax issue is whether the limited partnership will be deemed the "owner" of the property for federal income tax purposes. See Frank Lyon Co., supra.

V. H.R. 3110 - General Comments.

A. The Bill limits the cost recovery deductions with respect to "tax-exempt use property" to those determined using the straight-line method over recovery periods which are longer than the current ACRS periods. The definition of "tax-exempt use property," particularly the real property provision, is vague and replete with uncertainty. The following are merely the most obvious problems:

1. Proposed Section 168(f)(13)(C)(ii)(I) uses the term "related entity" without defining what is meant by the word "related." Is a county's bond issuing authority "related" to that county? Is a county "related" to the state within which it is located?
2. Proposed Section 168(f)(13)(C)(ii)(I) uses the phrase "participated in such financing" without providing guidance as to what constitutes "participation" in a bond financing. Does the term refer to personnel, process, guarantee, or some or all?
3. Proposed Section 168(f)(13)(C)(ii)(III) states that "tax-exempt use property" includes property used by a tax-exempt entity where the tax-exempt entity or a "related entity" (again undefined!) "protects the lessor from loss on his investment in the property so used." What does this investment protection clause mean? Does a "triple net lease" (which is common in sale-leasebacks because of its substantial effect on the availability and cost of financing) protect the lessor from loss on investment?

B. The Bill makes no distinction between governmental entities and other tax-exempt entities such as hospitals and universities. If a profit-making hospital or school can take advantage of the tax and economic benefits available in a sale-leaseback or leasing transaction, then why should not a tax-exempt hospital or university be able to obtain such benefits?

C. The Bill has a minimal impact on what the Bill's proponents apparently view as the most abusive transaction - the sale-leaseback of existing buildings. The vast majority of these transactions are governed by the "anti-churning" rules and, consequently, ACRS treatment is unavailable in any event. Conversely and unfortunately, the Bill has its greatest impact on the development and construction of new projects (or substantial rehabilitation of older buildings) which would be eligible for ACRS. Thus, the bill will diminish, in these times which trouble us all, both new construction and renovation and rehabilitation of run-down buildings by sharply reducing the available cost recovery deductions. The impact on jobs in the construction industry as well as on additions to the property tax rolls would also be significant and so adversely affect or further damage labor, local government and charitable organizations.

D. The Bill's approach does not deal, or at least rationally and fairly, with the supposed evil. If the supposed sale of the tax benefits of ownership by a governmental or tax-exempt organization is somehow wrong or undesirable, then the culprit is the governmental or tax-exempt organization, and it should lose its exemption or suffer some tax penalty. What rational policy is served by denying, for identical facilities, the tax consequences of ownership to the owner-developer when it leases to a tax-exempt lessee rather than a profit-making one? Of course, behind this entire process is a badly-crafted and administered income tax law and system featuring excessive, politically motivated nominal rates and the never-ending quest for relief by turning clumsiness and chaos to advantage. This Bill is a harmful diversion from dealing with this root problem. Gresham's law, applied to tax devices, will, by piggishness and wild extension of such practices, lead inevitably to corruption and failure. Why not let the courts and the IRS pick up the pieces?

E. The Bill's sponsors allege that sale and leasebacks add to the user's occupancy costs. I do not believe that at the state and local level this statement is accurate; my experience is to the contrary. I cannot adduce experience on the vagaries of federal procurement and practice.

F. The Bill's sponsors apparently believe sale-leasebacks, or variants are a novel, dangerous threat. Under President Eisenhower, post offices were privately owned and leased to the Federal Government. It is difficult to see how any decline in Washington can be assigned to this cause.

G. Perhaps the most insidious aspect of the Bill is the effective date - May 23, 1983. Although there is a "grandfather clause" for contracts entered into by May 23, 1983, it is the nature of these sale-leaseback transactions that binding contracts are not entered into until closing. Many deals (a number of which we see around the United States) which are well under way in terms of planning, negotiation and the incurrence of substantial costs (but which have not formally "closed") will be subject to the Bill.

1. In fact, this Bill's effective date is representative of a disturbing trend in Congress. Just the introduction of this bill with its May 23, 1983 effective date casts a cloud over the entire area. Governmental and tax-exempt entities and private developers, and their attorneys, are unsure whether to proceed with well-developed plans which are short of closing. No doubt this

is the effect intended by the proponents of the Bill. But such action is, in effect, legislation (is not an action by a lawmaker which inhibits or encourages behavior legislation?) by one Member of Congress (or a few Members) without the support of the rest of Congress and the signature of the President.

2. It is doubtful, from the facts, that a serious problem exists, that this Bill represents a desirable approach if a problem exists, that this technically-flawed Bill should or will be quickly enacted, that if enacted much harm would be done because of deal time lags if the effective date were made prospective, or that our legislative bodies should sacrifice or modify our concepts of fairness to nab a few supposed tax miscreants. In any event, principles of openness and fairness suggest that the Committee quickly issue some statement that new legislation will not be retroactive so as to enable the closing of transactions already near completion. Prospective deals will remain chilled, however dubiously.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. No questions. I would like to thank the speaker.

Mr. SCHLENGER. Thank you.

Chairman ROSTENKOWSKI. Thank you, gentlemen, for appearing with us today.

The committee will stand in recess until 1:30.

[Whereupon, at 12:20 p.m., the committee recessed, to reconvene at 1:30 p.m.]

AFTERNOON SESSION

Chairman ROSTENKOWSKI. The committee will come to order.

The Chair wants to welcome the ladies and gentlemen on the panel. We are happy that you are joining us this afternoon to participate in this discussion.

I understand, Mr. Edson, you have to leave. For that reason, we will give you an opportunity to testify first.

However, I would like to say that our ordinary format is that each member of the panel present their statement and then the members of the committee will engage in an exchange with each of you.

Mr. Edson, you may proceed.

STATEMENT OF CHARLES L. EDSON, COUNSEL, NATIONAL LEASED HOUSING ASSOCIATION

Mr. EDSON. My name is Charles L. Edson, a partner in the D.C. law firm of Lane and Edson, and counsel to the National Leased Housing Association, on whose behalf I am testifying here today.

First, I want to thank you for the courtesy that you have just extended. I will try to stay as long as I can, but I did not realize that it would be going this long.

Second, I would like to point out that the National Leased Housing Association got its name from the old section 23 leased housing program. We have nothing to do with sale and leasebacks. I wanted to make that clear to the committee.

We are a representative group of city governments, local housing authorities and State housing agencies, as well as private sector entities such as developers, financers, anyone involved originally in the old section 8 program, and now who are concerned with providing decent rental housing for low- and moderate-income Americans. And it is because of our interest in such housing that we are here today to address section 1(c) of H.R. 3110.

As a matter of background, there is a great rental housing shortage in this country. Indeed, in the 1979 report, the General Accounting Office had termed it a crisis in rental production. The needs have been estimated at 170,000 to 300,000 a year. In 1981, there were only 45,000 starts.

The only bright light in the rental picture in the past few years, other than section 8, has been housing financed generally with tax-exempt revenue bonds under section 103(b)(4)(A) of the code. This committee very wisely restricted these bonds in 1979 and 1980 to assure that 20 percent of the units must be for lower income families.

However, in one particular part of our country—and that is our center cities and declining areas—the incentive of tax-exempt financing is generally not enough to get the rental housing built; because of the high operating costs, security problems, rent control or the threat of rent control, extra incentives are needed. During the past 2 years, that incentive has proven to be the 25-percent Historic Preservation investment tax credit.

Working in tandem, the ITC, along with tax exempt financing, has produced badly needed rental housing. You will hear about case studies today in Savannah and Louisville, and similar examples could be provided in Boston, Pittsburgh, Cincinnati, Richmond, Portland, and the city of St. Louis.

So, as a result of the combination of the ITC and tax-exempt financing, we have preserved historic structures and moderate income housing in our inner cities and provided a cornerstone to the overall revitalization of these communities.

We are not talking about, the rehabilitation credit because it does not apply to rental houses. The President's Commission on Housing recommended that the rehabilitation credit apply to rental housing, and we totally agree. However, rental housing does benefit from the rehabilitation credit because if there is commercial revitalization in an inner city, usually a rental project is part of it.

For these reasons, we appear today to state our opposition to section 1(c) of H.R. 3110, which would preclude the combination of industrial development bond financing and the historic rehabilitation investment tax credit. For the reasons above-stated, this provision goes in the wrong direction if we wish to both provide rental housing generally for moderate income families and revitalize our cities.

On the specific point on the effective date—and this is if you adopt the provision, which we really hope you don't—we believe there really was a technical glitch in it, because it only exempts those projects with binding contracts if you are a tax-exempt entity. However, many of the developers are not tax exempt, and they would not be protected even if they had a binding contract, either to purchase a project or to do the rehabilitation on it.

I don't think it was the intent of the drafters to leave out that group from the protection of your effective date clause if they had such a binding contract, and we urge in any event that if you do enact the legislation to take care of that technical problem, because there are people who are really out on a limb now who have bought property and entered into contracts on the basis of present law before May 23d.

Again, Mr. Chairman, I thank you for the opportunity to appear—and appear out of turn—and to have your attention today.

Chairman ROSTENKOWSKI. Thank you, Mr. Edson.

[The prepared statement follows:]

STATEMENT OF CHARLES L. EDSON, COUNSEL, NATIONAL LEASED HOUSING ASSOCIATION

My name is Charles L. Edson. I am a partner in the Washington, D.C. law firm of Lane and Edson, P.C. and counsel to the National Leased Housing Association, on whose behalf I am testifying today.

As a matter of background, the National Leased Housing Association has nearly 800 member organizations—city governments, local housing authorities, state housing finance agencies, as well as developers, financiers and non-profits—concerned with the development and maintenance of rental housing for low, moderate and middle income Americans. Formerly, our major concern was HUD's Section 8 program, but with its demise, we are shifting our focus to any governmental assistance that fosters rental housing in this country. We appear today to state our opposition to Section 1(c) of H.R. 3110, which would preclude the use of the historic or rehabilitation credit when tax exempt financing is involved.

As a matter of background, because there is no longer a subsidized federal rental production program, we are nearing what the General Accounting Office has termed a crisis stage in rental production in this country. There have veen varying estimates of the annual production need from 170,000 to 300,000 per year. This estimated need should be contrasted with the 45,000 multifamily housing starts which occurred on an unsubsidized basis in 1981.

The only bright light in affordable multifamily production has been those projects that have resulted from tax exempt financing under Section 103(b)(4)(A) of the Internal Revenue Code. As a result of such financing, the owners debt service is lowered, which means lower rents for the project tenants. As you are aware, 15 to 20 percent of those tenants must be lower income families. Accordingly, the provisions which you have wisely included in Section 103(b)(4)A) have produced much badly needed housing.

However, tax exempt financing alone is generally not enough of an economic incentive to induce the construction of rental housing, especially in our inner city areas. It is there that affordable rental housing is most needed, and it is there that the financial incentives are most lacking, due to high operating expenses, security problems, and rent control or the threat thereof. One incentive that has existed to make such inner city rental housing possible is the combination of the historic preservation 25 percent investment tax credit with tax exempt financing. Working in tandem, the historic ITC and the lower debt service resulting from industrial bond financing has produced needed rental housing in inner city areas in such diverse communities as Boston, Pittsburgh, Cincinnati, Savannah, Louisville, Richmond, Beaumont, Texas, Portland, Oregon, Seattle and St. Louis.

The combination has produced the following salutary results:

Preservation of historic structures which otherwise would have fallen into disuse;

Provision of moderate income housing in our inner cities and other older areas;

Providing a corner stone to the overall revitalization of inner city communities.

Although the emphasis of our organization, and thus our testimony, is on rental housing, it is equally clear that much inner city revitalization has come through the combination of the commercial rehabilitation 15/20 percent credit and industrial development and bond financing.

Unfortunately, the rehabilitation credit is not available for rental housing, which we think is a weakness in the present law and join with the President's Commission on Housing in urging the availability of such credit in this area. However, rental housing has indirectly benefitted from the combination of the rehabilitation credit with tax exempt financing, as it leads to an overall community revitalization which can only benefit rental housing projects contained in our older areas.

For these reasons, we appear today to state our strong opposition to Section 1(c) of H.R. 3110 which would preclude the combination of industrial development bond financing and the historic rehabilitation investment tax credit. For the reasons above-stated, this provision goes in exactly the wrong direction if we wish to both preserve and revitalize our historic resources and provide badly needed housing.

We believe that Section 1(c) should not be included in any legislation; hovever, if the Committee sees fit to include such a provision, there should be a change in the effective date of the provision in Section 1(d). We understand that the intent of the effective date provision is to protect any party who had a binding contract to rehabilitate a historic structure as of May 23, 1983. Unfortunately, Section 1(d) only applies to tax exempt entities who have entered into such binding contract, and not to private entities who have relied on prior law. We urge the committee to amend Section 1(d) to protect both private and public entities having written binding contracts before May 23, 1983, who are rehabilitating projects that have both Section 103(b) financing and have utilized the historic preservation and rehabilitation tax credit.

Thank you for the opportunity to appear before you today.

LAW OFFICES,
LANE AND EDSON, P.C.,
Washington, D.C., June 28, 1983.

Re: H.R. 3110

Hon. J. J. PICKLE,
Room 242, Cannon House Office Building, Washington, D.C.

DEAR CONGRESSMAN PICKLE: On June 8, 1983, my partner Charles L. Edson, testified before the Ways and Means Committee on behalf of the National Leased Housing Association.

I am writing to you today to supplement his testimony, both on behalf of the National Leased Housing Association and on behalf of the Coalition for Low and Moderate Income Housing, which we also represent.

In reviewing H.R. 3110 further, we have encountered two problems with the definitions contained in such legislation and we would like to bring them to your attention prior to the mark-up.

First, we recommend that proposed Subsection 168(f)(13)(C)(ii) be amended to read as follows (underscoring indicates new language):

> "(ii) FIFTEEN-YEAR REAL PROPERTY.—In the case of 15-year real property, the term 'tax-exempt use property' means any property (*other than residential real property*) to the extent used by a tax-exempt entity where—"

Secondly, we recommend that proposed Subsection 168(f)(13)(D)(i) be amended to read as follows (underscoring indicates new language):

> "(i) the United States, any State or political subdivision thereof, any possession of the United States, any foreign government, any international organization, or any *tax-exempt* agency or instrumentality of any of the foregoing."

The first correction proposed above would, in effect, except residential rental property sold and leased back by a public housing authority or similar governmental agency from the effect of H.R. 3110. Substantially all of such housing is low and moderate income housing, and much of it is in a state of considerable deterioration. One of the few ways that public housing authorities and similar agencies can obtain the funds necessary to modernize such housing is to sell it to a limited partnership for purposes of syndication and then to lease it back. Ultimately, the housing reverts entirely to the public authority.

Since public housing authorities cannot levy taxes, since Congress is eliminating or drastically reducing most of the direct subsidies related to housing, and since public housing authorities are not the objects of charity, without the ability to raise funds by this method, much public housing will eventually fall into total disrepair and may have to be eliminated entirely from the nation's housing stock. In view of the dramatic need in this country for housing for low and moderate income individuals, we urge you not to close off this method of modernizing, improving and maintaining such housing.

The second correction proposed above would make it clear that certain *taxable* entities, which for other purposes may be considered agencies or instrumentalities of the United States, are not to be considered as such for purposes of H.R. 3110, since they fall outside the intent of the legislation. We have in mind, for example, the National Railroad Passenger Corporation (AMTRAK), the Federal National Mortgage Association (FNMA), and similar entities established by Congress, which for some purposes are considered agencies or instrumentalities, but which for most practical purposes are private corporations subject to all federal income taxes. Unless this amendment is made, uncertainty will be created as to whether H.R. 3110 applies to them, and, in the case of AMTRAK, its ability to renovate and rehabilitate structures such as old railroad stations and to restore them to viable commercial uses, may be greatly hampered or impeded.

Thank you for your consideration of these points.

Sincerely yours,

BRUCE S. LANE.

Chairman ROSTENKOWSKI. Mr. Adler, you may proceed.

Mr. ADLER. Mr. Chairman, if you don't mind, I would like Ms. Albani to come next.

STATEMENT OF SUZANNE B. ALBANI, ATTORNEY, CUMMINGS & LOCKWOOD, GREENWICH, CONN., ON BEHALF OF PRESERVATION ACTION, ACCOMPANIED BY LEOPOLD ADLER II

Ms. ALBANI. Thank you. I appreciate the opportunity to appear here and testify on H.R. 3110.

Mr. Chairman, my name is Suzanne Albani. I appreciate the opportunity to present my views on H.R. 3110 to you and the other members of the committee. I am an attorney with Cummings & Lockwood, a Connecticut-based law firm. In that capacity, I represent a number of colleges and universities in structuring sale/leasebacks to rehabilitate their older campus buildings. It is because of this experience that I have been asked to speak today on behalf of Preservation Action, the national citizens lobbying organization for historic preservation.

I am sensitive to the abuses in leasing arrangements with tax-exempt entities that H.R. 3110 attempts to address, and I support its general thrust. However, there are important distinctions to be made between abusive and nonabusive sale/leasebacks. My comments will suggest some recommendations which would retain the bill's intent to stop abuses without penalizing nonprofit organizations such as colleges and universities that wish to rehabilitate their campus buildings.

In the written statement that I have submitted to the committee, I have suggested specific language to prevent abuses while, at the same time, encouraging historic renovation. This language would exclude from the definition of tax-exempt-use property any portion of such property which is attributable to qualified rehabilitation expenditures provided that IDB financing was not used, and further provided that there was not a fixed price purchase or sale option in the lease or that the lessor was not protected against the risk of loss.

Without such a modification, I believe Congress policy to encourage rehabilitation of older and historic buildings will be thwarted. This is primarily because it is estimated that upward of 50 percent of the historic buildings in the Nation are currently owned by tax-exempt entities. These entities face a very severe financial burden in doing the necessary rehabilitation to these buildings.

It was in recognition of this fact that Congress enacted the 1981 amendment which allows the rehabilitation credit to be used on property leased to tax-exempt entities, thereby allowing them to indirectly benefit from the rehabilitation incentives. Nonprofits, including colleges and universities, are just now beginning to utilize these incentives, and H.R. 3110 would significantly cut back on them.

I know that all of you have read newspaper headlines recently which illustrate how governmental entities and other tax-exempt organizations have abused these tax incentives, and I fully support your effort here today and in this bill to clamp down on those abuses. But I would urge you not to throw away the good with the bad.

I would like to give you a specific example of a nonabusive sale/leaseback arrangement which ought to be encouraged, and which, I think, Congress intended to encourage when it passed the 1981 amendment.

Smith College is a private liberal arts school located in Northampton, Mass. It currently owns a historic building which has stood vacant for a number of years because Smith has not been able to raise the capital funds necessary to do the rehabilitation. The 1981 Tax Act provided a means by which Smith could attract private capital to do the rehabilitation while, at the same time, being able to use the building for its educational purposes.

What Smith is contemplating is selling its building to a group of private investors for its fair market value. Those investors would then make the rehabilitation and lease the building back to Smith at its fair rental value. At all times the private investors would enjoy both the benefits and the burdens of ownership. They would be taxable on the rental income produced by the property. The property itself would be put on the tax rolls of Northampton, thus generating revenues for that hard-pressed municipality.

The rent and the tax benefits combined make this an attractive investment. However, if you take away more than half of the depreciation deductions, which is what H.R. 3110 would do, this would not be an attractive investment and it is highly unlikely that Smith will be able to rehabilitate the building in this manner.

I don't believe it is in the public interest to discourage this kind of historic rehabilitation. The revenue loss, if any, is small when compared to the additional revenues generated by the jobs which would be created by this $3 million construction project, by the fact that this property would go on the tax rolls and by the fact that the property would be transferred to a taxable entity.

I would welcome the opportunity to make myself available to members of the committee and their staff to work out a compromise in which the abuses can be remedied, but that congressional policy to encourage historic rehabilitation can continue.

Thank you. I will be glad to answer any questions that you have.

[The prepared statement follows:]

STATEMENT OF SUZANNE B. ALBANI, ATTORNEY-AT-LAW, CUMMINGS & LOCKWOOD, GREENWICH, CONN.

Also appearing on behalf of Preservation Action, the national citizens lobbying organization for historic preservation.

A. SUMMARY OF COMMENTS

1. Congress' often expressed intention to encourage the rehabilitation of older and historic buildings culminated with the enactment of the Economic Tax Recovery Act of 1981 which increased the amount of the rehabilitation credit and for the first time allowed it to be claimed with respect to property used by tax-exempt entities.
2. Abusive use of these tax incentives, such as a purported sale/leaseback transaction in which the tax-exempt entity transfers only "nominal" ownership of the property to a taxable entity while retaining the benefits and burdens of ownership, ought to be prevented.
3. H.R. 3110 fails to make the necessary distinction between an abusive sale/leaseback and a legitimate one which has underlying economic consequences apart from tax considerations.
4. The failure to make such a distinction discriminates against tax-exempt organizations such as colleges and universities owning older and historic buildings in need of rehabilitation by denying them benefits available to taxable entities. It will have the effect of discouraging the preservation and rehabilitation of much of the nation's stock of such buildings.

5. In a legitimate sale/leaseback arrangement, the property is sold for its fair market value, rehabilitated and then leased back at its fair rental value. The owner/lessor is subject to tax on the income produced by the asset. The owner enjoys the benefits of any appreciation in value of the property and bears the risk of any depreciation in value. Furthermore, the property is put on the tax roles and thus will generate revenues for the municipality in which it is located. In such a situation, the owner/lessor should not be denied the full benefits of the available tax credits and ACRS deductions.

6. The ERTA amendment to Code Section 48(a) (4) and (5) allowing the rehabilitation credit with respect to property leased to tax-exempt entities is meaningless unless it was Congress' intent to allow tax-exempt entities to indirectly benefit from the tax incentives available in connection with the rehabilitation of older buildings. It makes little sense to allow the rehabilitation credit, but to deny the full measure of ACRS deductions unless Congress' intent to encourage the rehabilitation of older structures has changed since 1981.

B. RECOMMENDATION

1. H.R. 3110 should be modified to provide that "tax-exempt use property" does not include any portion of the basis of such property which is attributable to qualified rehabilitation expenditures, provided that (a) such property is not financed by industrial development bonds, (b) the lease does not contain a fixed price purchase or sale option, and (c) the lessor is not protected against risk of loss by the tax-exempt entity.

STATEMENT

Mr. Chairman, my name is Suzanne Albani, I appreciate the opportunity to present my views on H.R. 3110 to you and the other members of the Committee. I am an attorney with Cummings & Lockwood, a Connecticut based law firm. In that capacity, I represent a number of colleges and universities in structuring sale/leasebacks to rehabilitate their older campus buildings. It is because of this experience that I have been asked to speak today on behalf of Preservation Action, the national citizen's lobbying organization for historic preservation.

I am sensitive to the abuses in leasing arrangements with tax-exempt entities that H.R. 3110 attempts to address and I support its general thrust. However, there are important distinctions to be made between abusive and non-abusive sale/leasebacks. My comments will suggest some recommendations which would retain the bill's intent to stop abuses without penalizing non-profit organizations such as colleges and universities that wish to rehabilitate their campus buildings.

H.R. 3110 is intended, among other things, to prevent abusive sale/leaseback arrangements involving tax-exempt organizations where the tax-exempt entity transfers only "nominal" ownership of the property to the taxable entity while retaining the benefits and burdens of ownership. The bill, however, fails to make the necessary distinction between this abusive kind of sale/leaseback and legitimate sale/leaseback arrangements having underlying economic consequences apart from tax considerations. Failure to make this distinction will put non-profit organizations at a disadvantage *vis a vis* identical sale/leaseback arrangements involving for-profit organizations. As a result, the bill may have the unintentional effect of discouraging the rehabilitation of older and historic buildings currently owned by tax-exempt entities.

A significant percentage of the nation's stock of older and historic structures are currently owned by tax-exempt entities.

Many rehabilitations are only marginally economic even with the current tax incentives. Non-profit groups such as colleges and universities are far more likely to undertake such marginal projects because of their added aesthetic incentives to preserve these buildings then a typical real estate developer looking at the highest and best use of the property would be. If the non-profit organization cannot take advantage indirectly of the tax incentives, however, the cost of the rehabilitation becomes prohibitive and economically unjustifiable.

Since a sale/leaseback arrangement is the only way in which older and/or historic buildings owned by such entities can benefit from the rehabilitation incentives promulgated by Congress in 1981, H.R. 3110, in its present form, could thwart the legitimate public interest which is served by encouraging the preservation and rehabilitation of such older buildings. I, therefore, recommend that H.R. 3110 be modified to allow the full benefit of ACRS deductions where there is a legitimate sale/leaseback of property by tax-exempts which accomplishes the goal of reducing the cost of such rehabilitation without abusing the tax laws.

I. Background

On August 4, 1981 Congress passed the Economic Tax Recovery Act of 1981 ("ERTA"). Included in ERTA was an amendment to Section 46(a)(2)(F) of the Internal Revenue Code which increased the amount of the rehabilitation credit from 10 percent to 15 percent, 20 percent or 25 percent, depending on the age of the building and whether it is a certified historic structure.

At the same time, ERTA amended Code Section 48(a)(4) and (5) to permit for the first time the rehabilitation tax credit to be claimed with respect to rehabilitated property used by tax-exempt entities. The scope of this amendment was narrow; it was limited to that portion of the basis of "any qualified rehabilitated building" used by a tax-exempt organization or governmental unit pursuant to a lease "which is attributable to qualified rehabilitation expenditures."

These amendments were concrete evidence of Congress' acknowledgement of the benefits to our society and economy of encouraging the rehabilitation of older and historic buildings, irrespective of whether or not such structures are used by tax-exempt organizations. According to a Report of the House Committee on Ways and Means on H.R. 7956 (the forerunner of the ERTA amendment to Code Section 48(a)(4) and (5)), the Committee believed that such an amendment was necessary because "the present law exceptions to allowance of the investment credit for property leased to tax-exempt organizations and governments operate to significantly impair Congressional intent to encourage the rehabilitation of older structures." [1]

A principal reason set forth by those in favor of limiting the tax benefits available to owners of property leased to tax-exempt organizations is that it enables a portion of the tax benefits to be passed through to the tax exempt lessees in the form of lower rents. These rents are, of course, negotiable, and even in a leasing arrangement with a taxable entity, they would be set lower to reflect the cost savings resulting from the tax benefits.

The ERTA amendment to Code Section 48(a)(4) and (5) is meaningless unless it was Congress' specific intent to allow tax-exempt entities to indirectly benefit from the tax incentives available in connection with the rehabilitation expenditures incurred on older buildings. This was the obvious conclusion to be drawn when ERTA was passed in 1981, and a number of non-profit groups have acted in reliance on that clear expression of Congressional intent. For Congress to act less than two years later to prohibit the pass-through of some of these rehabilitation tax incentives to tax-exempt entities makes sense only if it has decided that the public interest is no longer served by encouraging the preservation and rehabilitation of our older and historic buildings. I am not aware of anything that indicates that Congress has come to these conclusions. The public interest to be served by such rehabilitation is just as real in 1983 as it was in 1981.

II. Abuses Which Should Be Remedied

H.R. 3110 seeks to remedy the abuses that are perceived to exist in various leasing arrangements by tax-exempt entities. The parts of the bill directed at these abuses which effect the rehabilitation of older and historic buildings are the provisions which would (i) deny the rehabilitation credit for expenditures financed by tax-exempt industrial development bonds; and (ii) extend the recovery period of real property from 15 years to 35 years.

Most people would agree that allowing a tax-exempt organization to enjoy the benefits of the rehabilitation credit and ACRS deductions as well as tax-exempt financing is a "double dip" that Congress never intended and therefore ought to be prevented.[2] More importantly, the full benefits of ACRS ought not to be available to an entity which is only a "nominal" owner/lessor of property. These situations are adequately addressed by H.R. 3110's definitions I, II and III of "tax-exempt use property" contained in Paragraph 13(C)(ii) to be added to Code Section 168(f).

Extending the recovery period of real property from 15 to 35 years in a non-abusive sale/leaseback arrangement, however, does not serve any public interest.

III. Exception for Non-Abusive Rehabilitation Sale/Leasebacks

The inclusion in H.R. 3110 of definition IV in Paragraph 13(C)(ii) is troublesome because of its all-inclusiveness. It defines "tax-exempt use property" in the case of 15-year real property to mean property where "such use occurs after a sale or lease of the property by such [tax-exempt] entity . . . and a leaseback." This very broad definition sweeps within its reach those sale/leasebacks which are a true sale at fair rental value and a true leaseback at fair rental value.

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[1] Miscellaneous Revenue Act of 1980, Report of the Committee on Ways and Means, U.S. House of Representatives, Sept. 4, 1980, p. 21.

[2] H.R. 3110 goes too far, however, in denying the rehabilitation credit in any situation where industrial development bond financing is used. This will have a tremendously adverse effect on the revitalization of many of our older cities and urban areas.

If definition IV is interpreted to mean that the qualified rehabilitation expenditures made by a taxable entity to a building purchased from a tax-exempt entity at fair market value and leased back to that entity at fair rental rates would have to be depreciated over a 35-year period instead of over a 15-year period, it would drastically reduce the economic feasibility of doing the rehabilitation. A proposed rehabilitation project currently contemplated by Smith College in Northamption, Massachusetts provides an example of this.

Smith College owns a building that is located in a certified historic district and which is eligible for designation as a certified historic structure. For the last several years the building has remained vacant because of its dilapidated state. Renovations to make it useable would cost $3,000,000. The college cannot obtain the capital to do the rehabilitation itself, and if the building isn't renovated soon it will have to be torn down because of its rapidly deteriorating condition.

The 1981 amendment to Code Section 48(a)(4), which allows the rehabilitation credit to be claimed with respect to property used by tax-exempt organizations, provided Smith with an opportunity to save the building and still be able to use it for educational purposes. Accordingly, Smith is contemplating selling the building to private investors for its fair rental value. The investors will rehabilitate it and, since they would be able to claim the 25-percent rehabilitation credit, the effective cost of the rehabilitation to them would be $750,000 less than it would be if Smith did it. The investors will then lease the building back to Smith at its fair rental value. The rent plus annual depreciation deductions of $200,000 on the rehabilitation expenditures will be sufficient to make this an attractive investment for the investors. After the investors recover their investment, they will own an income producting asset which they can continue to rent or sell to realize its appreciated value.

The college will benefit because it will have the use of the building, both without having to raise the capital funds necessary to do the rehabilitation, and at a lower rent than presumably would have been the case if the investors were prohibited from utilizing the rehabilitation credit and the normal ACRS rules.

If, however, the recovery period of the rehabilitation expenditures is extended to 35 years, the annual depreciation deductions would be reduced by $114,285. Such a reduction significantly changes the economics of the transaction by lengthening the number of years it would take for the investors to recover their investment. Moreover, it would result in a negative after-tax return on their investment rather than a positive one, prior to repayment of the mortgage proceeds used to finance the rehabilitation. It is highly unlikely that Smith will be able to attract private investors willing to undertake the rehabilitation under these conditions. Instead, such investors will invest their money in a rehabilitation project with a non tax-exempt entity where they will be entitled to the full benefit of ACRS deductions.

I do not believe it is Congress' intent to prevent rehabilitations such as the one described above from taking place. In a legitimate sale/leaseback such as the one contemplated by Smith, property that is now serving no function and producing no taxable income will be transferred to a partnership whose partners will be subject to tax. Furthermore, citizens of Northampton, Massachusetts will benefit from the jobs produced by $3,000,000 construction project and the City of Northampton will benefit from the fact that the property will be subject to real estate taxes. It seems particularly inequitable to deny the full benefit of ACRS deductions to a transaction which results in placing formerly tax-exempt property on the tax rolls.

IV. Recommendation

The preservation, rehabilitation and adaptive reuse of our older buildings, particularly those with historic significance, ought to be encouraged. Congress recognized this in 1981 when it modified the rehabilitation credit provisions of Section 48 of the Code to increase the amount of the credit and allow it to be claimed in respect of property used by tax-exempt entities pursuant to a lease. The preservation of such buildings ought not to be discouraged now by reducing the depreciation deductions allowed in respect of their rehabilitation. At the same time, abusive use of the tax benefits ought to be prevented.

Accordingly, it should be made clear that the qualified rehabilitation of property acquired from a tax-exempt entity and leased back to it should be treated as separate property eligible for the 15-year recovery period of ACRS in transactions which do not involve either a financing with tax-exempt industrial development bonds, or a transfer by the tax-exempt entity of only nominal ownership of the property to the taxable entity. I propose that Section 1(a) of H.R. 3110 be modified to include the following language in the new Paragraph 13 to be added to Section 168(f) [new language in italic]:

"(C)(iii) EXCEPTION WHERE PROPERTY USED IN UNRELATED TRADE OR BUSINESS *OR WHERE PROPERTY IS A QUALIFIED REHABILITATION.*—The term 'tax-exempt use property' shall not include

"(I) any portion of property predominantly used by the tax-exempt entity in an unrelated trade or business the income of which is subject to tax under Section 511, *or*

"(II) any portion of the basis of such property which is attributable to qualified rehabilitation expenditures, provided that the use of such property does not consist of uses described in subparagraph (C)(ii) (I), (II), or (III) of this paragraph."

With the addition of this language to H.R. 3110, abusive leasing arrangements can be prevented without unfairly penalizing legitimate sale/leaseback transactions entered into with tax-exempt entities for the purpose of rehabilitating older and historic buildings.

STATEMENT OF LEOPOLD ADLER II, SAVANNAH LANDMARK REHABILITATION PROJECT, SAVANNAH, GA., ON BEHALF OF PRESERVATION ACTION

Mr. **ADLER**. Mr. Chairman, my name is Leopold Adler II, and I am from Savannah, Ga. I am a trustee emeritus of the National Trust and past chairman of Preservation Action and chairman of the Americans for Historic Preservation.

We are very concerned about this bill because we have been working in the areas of public housing trying to rehabilitate housing for low income people. We have been able to do this successfully only because of the Tax Act, which allows the ITC to be used in combination with IRB's.

We were talking yesterday with some of the staff about it and we decided—I drew up the question of the Baskin Robbins rule which is when you go in there you are not afraid to go get a double-dip because that is enough and the single-dip just does not work.

Now, IRBs have been around a long time and this alone did not accomplish significant preservation in inner cities. The commercial areas of most of the cities in this country and the inner city housing areas that need to be fixed and brought from intolerable conditions to good conditions, can't be done if this goes into law. Most of the cities of the country have redlined these areas and the banks have redlined them as well until the tax incentives were put in, which you wisely did. When IRB's were allowed to be used in conjunction with them, much is getting done.

An historic structure is finite. Unlike new buildings—one cannot get added height nor length for adequate profits—that is why one must have incentives to restore the sound old structures in this country.

These are risky areas and they must have help. They normally deteriorate to the point that they go off the tax rolls. But unlike public housing, also off the tax rolls, the inner city houses that we are dealing with, using the tax act and IRB, are put back on the tax rolls.

In Savannah, we are doing 400 apartments. There are a thousand on the waiting list. It has renewed the life of the people in the whole section of the city, and I get asked to speak every week on this. In fact, I am heading to Fredericksburg to do that at the end of this week. So I would like to make myself available for any questions about this because in cities like Annapolis, Pittsburgh, Cincinnati, New York, Kansas City, and Hartford, they are crying out for help and they want to do it in a way in which the private and public sectors can join to get something done.

Now, it does not take taxes away from governments in the city and county governments—it adds to them. It is revitalizing areas in this country which we have felt and we know have a problem, and which you know as one.

Thank you very much.

Chairman ROSTENKOWSKI. Thank you, Mr. Adler.

Mr. Schochet, you may proceed.

STATEMENT OF JAY SCHOCHET, PRESIDENT, SCHOCHET ASSOCIATES, BOSTON, MASS., ACCOMPANIED BY SHELDON L. SCHREIBERG, COUNSEL ON BEHALF OF THE NATIONAL HOUSING REHABILITATION ASSOCIATION

Mr. SCHOCHET. Good afternoon. My name is Jay Schochet and I am the president of the Boston development company, Schochet Associates. I appreciate your courtesy in considering the following comments on behalf of the National Housing Rehabilitation Association.

NHRA is the largest association of developers, underwriters and government officials active in the rehabilitation of residential and commercial structures in the country. With me is Sheldon Schreiberg, counsel for NHRA.

Our comments will address only the problem raised for historic preservation by a narrow portion of the proposed legislation, subsection (c), which prohibits the use of historic preservation or commercial rehabilitation investment tax credits for projects financed with tax-exempt industrial development bonds without regard to whether a sale/leaseback transaction is involved, going well beyond the stated intent of H.R. 3110, which we support.

It is difficult to understand why tax policy must contravene what is clearly national policy, articulated by the Congress, to support the preservation of historic buildings and districts not just as monuments but as commercially viable properties. If we accept this national commitment, we must accept several facts of life about historic preservation.

Buildings of historic value normally cost more to acquire. Buildings having historic significance often cost more to rehabilitate. The heaviest costs associated with these projects are frequently front-end costs. Buildings having historic designation are in general less efficient than new construction and require greater investment to produce equivalent rent rolls. The economies of historic preservation often require a greater proportion of equity to debt than other commercial projects.

The critical point today is that you understand the why of IDB's. Communities with marginal central cores frequently use the development of an historic property as a catalyst for redevelopment. Developers don't get up in the morning and place orders for IDB's. IDB's are not issued without public hearings. They are a tool by which cities can attract developers to come into difficult areas and spark the city's redevelopment plans.

The use of IDB's allows the private developer to deal with historic properties in marginal areas as a response to community needs.

My Los Angeles project is only one of 15 rehab projects in the Los Angeles central business district redevelopment project, and the city is in total support.

This legislation prevents this from happening. If you on the committee think of IDB's as a raid on the Treasury, you are mistaken. We all know the cheapest way to provide new space where an older property occupies a site is to tear it down. If I choose the rehab route, I would certainly rather walk into a private lender and make a conventional financing arrangement. Most developers would do the same.

In connection with one current project—for example, the Garfield Building, which is part of a Los Angeles central business district redevelopment—the following steps were involved: The requirement for an inducement resolution from the Community Redevelopment Agency; liaison with several layers of government—for example, a resolution of approval from the city of Los Angeles Planning and Environment Committee, and a city council resolution of approval; contact with a special financing agency; a public hearing; involvement of a rating agency; need for credit support documents; authorization by the city for contracts with underwriters, bond counsel; and a disposition and development agreement.

All this adds up to major front-end costs. In a current project, the cost of issuance came to 3½ points. We had to go to an insurance company to insure the bonds because the project was in such a marginal area, which cost another 8 percent.

An April report of the Advisory Council on Historic Preservation states that buildings eligible for Federal historic incentives represent only one-quarter of 1 percent of all buildings in this country. Of projects undertaken to date, according to another report, only 20 percent use IDB financing.

So we are not talking about a big deal, a major sector of the development market. We are talking about one-twentieth of 1 percent of all buildings. But these are structures that matter. We obviously do not want to lose them.

Eliminating or redrafting subsection (c) would not open a gold rush into the tax-exempt market; the IDB's simply provide a critical option where the numbers otherwise won't work and still preserve the intent of the bill.

One final point: Both as a private businessperson and as a spokesperson for the National Housing Rehabilitation Association, I want to express my serious concern with what seems to be a growing trend to write legislation such as this with an effective cutoff date on the date of introduction. In an area as volatile as the bond markets, creating that kind of uncertainty places a chill on the marketplace and brings deals that have been years in the making to a screeching halt. In my own case, after almost 3 years of effort, we are ready to close a deal on June 30 and simply cannot, and we are not a sale/leaseback transaction.

It is a perversion of the legislative process and grossly unfair when the threat of legislation accomplishes its purpose without the passage of any bill at all. If you are serious about the substance of this proposal, it would be far better and more equitable to have it effective on enactment, and to enact it swiftly after proper consideration. If you do so, I hope it is possible to clarify the legislative language to protect what increasingly seems a very fragile commitment to rehabilitation and historic preservation.

[The prepared statement follows:]

STATEMENT OF JAY SCHOCHET, PRESIDENT, SCHOCHET ASSOCIATES, BOSTON, MASS., ON BEHALF OF THE NATIONAL HOUSING REHABILITATION ASSOCIATION

Good morning. My name is Jay Schochet, and I am the president of a Boston development company, Schochet Associates. I appreciate your courtesy in considering the following comments on behalf of the National Housing Rehabilitation Association. NHRA is the largest association of developers, financiers, underwriters and government officials active in the rehabilitation of residential and commercial structures in the country. Our association had its roots in subsidized housing, particularly the Section 8 program, but today our members engage in the whole range of rehabilitation activities, from residential rehab to the rehabilitation of historic and nonhistoric properties as office buildings. With me is Shel Schreiberg, counsel for NHRA.

Our comments will address only the problem raised for historic preservation by a narrow portion of the proposed legislation, subsection (c), which prohibits the use of historic preservation or commercial rehabilitation investment tax credits for projects financed with tax-exempt industrial development bonds without regard to whether a sale-leaseback transaction is involved. Putting aside the equity of such an approach and whether it accurately reflects Mr. Pickle's stated intentions, I want to make a few specific points and illustrate those arguments with examples from actual projects.

1. It is difficult to understand why tax policy must contravene what is clearly national policy, articulated by the Congress, to support the preservation of historic buildings and districts not just as monuments but as commercially viable properties.

2. If we accept this national commitment, we must accept several facts of life about historic preservation:

a. Buildings of historic value normally cost more to acquire.

b. Buildings have historic significance often cost more to rehabilitate.

c. The heaviest costs associated with these projects are frequently front-end costs.

d. Buildings having historic designation are in general less efficient than new construction and require greater investment to produce equivalent rent rolls.

e. The economics of historic preservation often require a greater proportion of equity to debt than other commercial projects.

3. The critical point today is that you understand the why of IDBS. Communities with marginal central cores frequently use the development of an historic property as a catalyst for redevelopment. Developers don't get up in the morning and place orders for IDBs. IDBs are not issued without public hearings. They are a tool by which cities can attract developers to come into difficult areas and spark the city's redevelopment plans. The use of IDBs allows the private developer to deal with historic properties in marginal areas as a response to community needs. My Los Angeles project is only one of 15 rehab projects in the Los Angeles central business district redevelopment project, and the city is in total support.

Given this framework, the Congress has provided important tools to assist the developer of an historic property: accelerated cost recovery; investment tax credits; and, in some instances, IDB financing. These tools, again, support the preservation of a rich and diverse architectural heritage.

This legislation will kill those deals in marginal areas. If you on the committee think of IDBs as a raid on the Treasury, you are mistaken. We all know the cheapest way to provide new space where an older property occupies a site is to tear it down. If I choose the rehab route, I would certainly rather walk into a private lender and make a conventional financing arrangement. Most developers would do the same.

The IDB route is time consuming, costly and risky. The private financing can be accomplished in a matter of days. With the IDB alternative you can eat up months of time.

In connection with one current project, for example, the Garfield Building, which is part of a Los Angeles central business district redevelopment, the following steps were involved:

1. The requirement for an inducement resolution from the Community Redevelopment Agency.

2. liaison with several layers of government—for example, a Resolution of Approval from the City of Los Angeles Planning and Environment Committee, and a City Council Resolution of Approval;

3. contact with a special financing agency;
4. a public hearing;
5. involvement of a rating agency;
6. need for credit support documents;
7. authorization by the city for contracts with underwriters, bond counsel, and
8. a disposition and development agreement.

All this adds up to major front end costs. In a current project, the cost of issuance came to 3½ points. Credit rating costs came to 8 points. We had to go to an insurance company to insure the bonds because the project was in such a marginal area.

You only go through this process when you absolutely have to. It's not easy. It's not fun. It's very expensive.

Another NHRA not-for-profit member has just signed the commitments for a housing development that could not work if the language of H.R. 3110 remains unchanged. The non-profit developer, the Newton Community Development Foundation, is carrying out an "historic adaptive reuse" of an unused, older high school in Newton Centre, Massachusetts. The project will provide 65 units of mixed-income housing on completion. Half of the units will be Section 8; half are financed by the Massachusetts Housing Finance Agency using IDBs to reduce the mortgage on the non-section 8 units. Almost all the syndication profits go to the building; here a syndicated tax credit permits a not-for-profit corporation to produce mixed-income housing. This project and others like it could not be realized without using all the available financing options.

An April report of the Advisory Council on Historic Preservation states that buildings eligible for federal historic incentives represent only one-quarter of one percent of all buildings in this country. Of projects undertaken to date, according to another report, only 20 percent use IDB financing.

So we're not talking about a big deal, a major sector of the development market. We're talking about 1/20 of 1 percent of all buildings.

But these are structures that matter. We obviously do not want to lose them.

Eliminating or redrafting subsection (c) would not open a gold rush into the tax-exempt market; the IDBs simply provide a critical option where the numbers otherwise won't work.

Financing consistently is a greater hurdle for restoration than for other construction. There is current speculation, which I share, that the downward drift in interest rates may be coming to an end. I suggest it is important to preserve all available alternatives for rehabilitation.

One final point. Both as a private businessperson and as a spokesperson for the National Housing Rehabilitation Association, I want to express my serious concern with what seems to be a growing trend to write legislation such as this with an effective cut-off date on the date of introduction. In an area as volatile as the bond markets, creating that kind of uncertainty places a chill on the marketplace and brings deals that have been years in the making to a screeching halt. In my own case, after almost three years of effort, we are ready to close a deal on June 30 and simply cannot. It is a perversion of the legislative process and grossly unfair when the threat of legislation accomplishes its purpose without the passage of any bill at all. If you are serious about the substance of this proposal, it would be far better and more equitable to have it effective on enactment, and to enact it swiftly after proper consideration. If you do so, I hope it is possible to clarify the legislative language to protect what increasingly seems a very fragile commitment to rehabilitation and historic preservation.

I would of course be willing to answer questions and to supply any additional information the committee might request. Thank you.

Chairman ROSTENKOWSKI. Mr. MacRostie, you may proceed.

STATEMENT OF WILLIAM G. MacROSTIE, PRESERVATION CONSULTANT, LANGELIER HISTORIC PROPERTIES

Mr. MACROSTIE. Mr. Chairman, I am William MacRostie of Langelier Historic Properties, which is a Washington, D.C., based firm with activities in two areas surrounding the rehabilitation of older and historic structures. First, we raise equity capital for rehabilitation projects which utilize one of the investment tax credits for rehabilitation in sections 46(a) and 48(g) of the code. Second, we offer consulting services to owners and developers who are seeking certification from the Department of the Interior in order to take the 25-percent credit for historic structures. In both the equity-raising and consulting parts of our business, we have contacts with developers in all parts of the country; and as a result we see rehabilitation projects which have used or will be using a variety and combination of different financing techniques.

One of the methods of financing we have seen in a number of rehab projects is the tandem use of tax-exempt industrial development bonds and the investment tax credit. Due to the convergence of certain negative forces in a significant number of these projects, we believe that prohibition of the tandem use of IDB's and the ITC would make many of these projects economically infeasible and thus would cause them not to be undertaken by their developers.

The negative forces to which I refer here include situations where a developer is unable to obtain conventional debt financing due to the high-risk nature of his project as well as situations where the high cost of conventional debt financing creates a negative cash flow so large as to prevent prudent developers or investors from undertaking a project.

My purpose in offering this testimony this afternoon, therefore, is to argue against the inclusion in H.R. 3110 of section 1(c), which is entitled, "Rehabilitation Credit Not To Apply to Expenditures Financed by Tax-Exempt Industrial Development Bonds."

Both IDB's and ITC's play a critical role in keeping the debt service in projects we are familiar with at a moderately low level. The IDB's do so by providing debt financing below market interest rates, while the ITC allows equity to be raised and limits the amount of debt financing which needs to be obtained for a project.

I would like to proceed with a couple of examples which illustrate our opposition to section 1(c) of the bill. The first example is a 32,000-square-foot structure in Montgomery, Ala., which will be rehabilitated for office use.

The project developer has factored the 25-percent ITC and tax-exempt IDB financing into his operating pro forma. The debt service on the IDB financing at a 10-percent rate of interest will allow space in the building to be leased at an annual rate of $9.50 per square foot in the first year of operation. That rate is competitive with the current Montgomery office market.

With a conventional mortgage at 13 percent, the developer would be forced to increase rents to $11.50 a foot, which is a rate $1.50 to $2 above what the market will bear. The developer would not undertake the project knowing he could not obtain in the competitive market rents necessary to carry the project.

The second example involves a project in Cambridge, Mass., which will convert a 100,000-square-foot carriage manufactory to office and retail use. Rent levels at $12.50 per square foot are projected utilizing IDB tax-exempt financing. $12.50 a foot is at the upper end of the local rehab office space market in Cambridge.

Conventional financing—assuming a straight term loan could even be obtained by the developer—would drive the rents up to $14 per square foot, well above the top end of the market.

Based upon our discussions with these developers and many others around the country, we are concerned that the tandem use of IDB's and ITC's continue to be available to encourage developers to undertake projects in areas where market rental rates for rehabilitated buildings are not high enough to provide cash flow adequate to cover debt service at market interest rates.

Moreover, we believe it is important to allow the tandem use of these financing techniques for buildings where lenders are unwilling to provide debt financing due to the transitional location of many historic and older buildings which are candidates for rehabilitation.

Chairman ROSTENKOWSKI. The committee will suspend for approximately 10 minutes, so that we may vote.

[Recess.]

Mr. PICKLE [presiding]. I would ask the committee to come to order again.

The chairman suggested that we proceed with the hearings and he will be back shortly.

I understand that Mr. MacRostie was testifying. I don't know at what point you were interrupted. You may go ahead with your testimony.

Mr. MACROSTIE. Thank you, Mr. Pickle. What I will do is pick up where I left off in the statement.

Congressman Pickle's explanation of H.R. 3110——

Mr. PICKLE. Did you have to start with me? Where are you reading from?

Mr. MACROSTIE. The second-to-the-last paragraph in my statement.

Mr. PICKLE. All right. I've got you.

Mr. MACROSTIE. It appears from Congressman Pickle's explanation of H.R. 3110 in the May 24, 1983, Congressional Record that the primary thrust of the bill is directed toward disallowing favorable tax treatments in abusive sale/leaseback transactions. Moreover, there appears to be some discrepancy between Congressman Pickle's explanation of section 1(c) and the language of that section in the bill itself. It appears from Mr. Pickle's statement when the bill was introduced that its intent was to prohibit the tandem use of tax-exempt IDB financing with the ITC only on rehabilitation projects where tax-exempt entities are the ultimate users.

Taking into account the discrepancies between the language of the bill and the explanation of its intent, as well as the difficulty of financing the rehabilitation of older and historic buildings across the country, we would recommend to the committee amending H.R. 3110 by deleting section 1(c).

Mr. PICKLE. Thank you, Mr. MacRostie.

Now, I believe that Mr. Vice, representing the H-L Properties, has not testified.

Are you next?

Mr. VICE. Yes, sir.

Mr. PICKLE. Would you identify yourself and then proceed?

STATEMENT OF ROBERT B. VICE, PRESIDENT, H-L PROPERTIES, INC., LOUISVILLE, KY., ON BEHALF OF PRESERVATION ALLIANCE OF LOUISVILLE AND JEFFERSON COUNTY, INC., AND LOUISVILLE CENTRAL AREA, INC.

Mr. VICE. Good afternoon.

I appreciate the opportunity to address the committee this afternoon. My name is Robert Vice. I am president of H-L Properties, which is a wholly owned subsidiary of J. J. B. Hilliard, W. L. Lyons, Inc., a regional brokerage and investment banking firm. H-L Properties is engaged in equity financing of real estate, including older and historic buildings.

I am also, on a volunteer basis, chairman of the board of Preservation Alliance of Louisville and Jefferson County, a nonprofit broad-based coalition of over 50 organizations in Louisville and Jefferson County, committed to the preservation and continued use of our historical resources.

In addition, I am a member of the board of directors of Louisville Central Area, Inc., a nonprofit corporation of business, property owners and institutions working together with government for the improvement and economic vitality of the central business district of Louisville.

I am here today in my capacity with all three of these organizations to express concern over the impact that H.R. 3110 is going to have on the continued economic revitalization and preservation of histoic and older structures in Louisville. The bill seems to have two purposes: To eliminate sale/leaseback financing with tax-exempts and to prohibit the use in tandem of IDB financing with the rehabilitation credit.

Although all of the committee's testimony this morning has addressed only the former issue of sale/leaseback financing, I am concerned, as is our mayor, our county judge/executive and the three organizations I am with, about the impact of section 1(c) on the continued use of industrial revenue bond financing with the rehabilitation credit.

I first of all would appreciate if the committee, in its deliberations, would clarify the intent of the bill so that those developers in the private sector that are not involved in sale/leaseback transactions with tax-exempts would know whether the intended impact of this bill is on their developments and that the bill is, indeed, designed to eliminate so-called double-dipping by the use of IDB financing and rehabilitation tax credits.

You have heard testimony today by members of this panel that there is, in fact, no double-dipping of benefits when both the rehabilitating tax credit and the industrial development bonds are used. The rehabilitation tax credit is designed to partially offset the higher risks of cost overruns involved in the renovation of old or historic structures as well as the greater space inefficiencies and higher operating costs associated with the design of these buildings.

The use of IDB financing, on the other hand, is addressed to the operational phase of a building, and, unfortunately, the effect of this bill would be to allow developers of new buildings who qualify to use tax-free financing and therefore avail themselves of lower financing costs while those developers of historic or older buildings would not have that advantage.

You have heard testimony—and I have included it in my written statement before this committee—an example of the effect of the use of industrial development bond financing for new construction versus the effect of only having the availability of the rehabilitation credit for renovated structures. I think it is not unreasonable to expect the private sector developers to be thwarted from engaging in renovations and instead opt for developing new structures.

I would also like to spend a minute talking about an issue that addresses both the sale/leaseback rules proposed in this bill and the forced election between industrial development bonds and rehabilitation tax credits, and that is the economic and tax justifications for this bill. We have heard that it is against the Congressional Budget Office policy to include feedback in evaluating the tax revenue losses on the Treasury for tax benefits and tax incentives.

However, I think the committee must take notice of the fact that in both the sale/leaseback with tax-exempt situation as well as the situation with private developers, these projects are extremely labor-intensive—they are approximately 40 percent more labor-intensive—and therefore create jobs and income taxes paid. They create business profits from contractors and suppliers. They generate business income from the operation of the building itself as well as gain at a greatly appreciated value on the sale of that building, and, by increasing the tax base substantially reduce the dependence of the local governmental unit on Federal transfer payments.

I have cited in my testimony before the committee, as well as included as part of my testimony, letters from Louisville Central Area, Inc., the mayor of Louisville and the county judge/executive of Jefferson County, all attesting to the tremendous impact this combined use of tax incentives has had on the redevelopment of downtown Louisville. From 1973 to 1978, our tax base only increased from $210 million to $310 million in the central business district. However, from 1978 until 1985, it is expected to increase 120 percent to $680 million, and this is largely the result of the substantial renovation activity at an unprecedented rate that has taken place by the private sector in our community.

We urge you to, first of all, exempt from the coverage of this bill any ITC–IDB election in private sector transactions, and we ask you to consider the feedback that is generated by rehabilitation in sale/leaseback transactions as well as private sector transactions using IDB's and ITC, in considering whether there is, in fact, a net revenue loss to the Treasury.

[The prepared statement follows:]

STATEMENT OF ROBERT B. VICE, CHAIRMAN, PRESERVATION ALLIANCE OF LOUISVILLE AND JEFFERSON COUNTY, INC.

Honorable Members of the Ways and Means Committee of the House of Representatives:

I am President of H-L Properties, Inc., a wholly-owned subsidiary of J.J.B. Hilliard, W.L. Lyons, Inc., a regional brokerage and investment banking firm headquartered in Louisville, Kentucky. H-L Properties is engaged in the equity financing of real estate, including older and historic buildings. I am also Chairman of the Board of Directors of Preservation Alliance of Louisville and Jefferson County, Inc., a non-profit, broad-based coalition of over fifty organizations in Louisville and Jefferson County committed to the preservation and continued use of our historical resources. In addition, I am a member of the Board of Directors of Louisville Central Area, Inc., a non-profit corporation of business, property owners and institutions working together with government for the improvement and economic vitality of the Central Business District of Louisville.

STATEMENT OF THE ISSUES

This statement, submitted with my oral testimony before this Committee, will address the potentially damaging impact of H.R. 3110 on the continued economic revitalization of Louisville and the preservation of old and historic buildings in our community. Other communities across the county will also be adversely affected if this bill is enacted. Specifically, the provisions of H.R. 3110(c) would thwart the rehabilitation of older and historic buildings and retard the economic development of our Central Business District and the surrounding neighborhoods by prohibiting the use of tax-exempt industrial development bond ("IDB") financing for building renovations in which the rehabilitation credit is claimed. In addition, the provisions of H.R. 3110(a) and (c) would effectively eliminate the sale-leaseback financing that is necessary for the continued rehabilitation of old and historic buildings presently owned by tax-exempt entities that may not otherwise be able to afford the renovations. Finally, the transition rule contained in H.R. 3110(d)(1) would unfairly deprive taxpayers of incentives that they have relied upon in the many cases where buildings are presently being rehabilitated.

DISCUSSION

I. Both the Rehabilitation Credit and the Use of IDB Financing Must Be Available to Promote the National Policy of Rehabilitation of Older and Historic Buildings.

In 1966, Congress recognized the importance of historic preservation in the United States in adopting the National Historic Preservation Act, thereby making preservation of historic properties a national policy. For the first time since the passage of that Act, incentives provided in the Internal Revenue Code have begun to encourage the private sector to redevelop, renovate and reuse old and historic buildings through the rehabilitation credit and IDB financing. These two incentives, together, have worked effectively to promote substantial rehabilitation activity. The rehabilitation credit induces developers to incur the greater risk of cost over-runs associated with the rehabilitation of old and historic buildings and partially offsets the higher costs of operation from the inefficiencies in design of these older structures. Design review by local and state governments and the Interior Department as a precondition to the rehabilitation credit for historic structures has also improved the quality of these renovations. At the same time, the use of IDB financing reduces debt service expense so that the renovated buildings will be operationally feasible at competitive lease rates.

The stated purpose of H.R. 3110 is to prevent so-called "double dipping" of tax benefits. However, the rehabilitation credit and use of IDB's serve entirely different purposes, both of which are necessary. This is not a question of double dipping; the rehabilitation credit helps offset some risks and disadvantages of rehabilitating older structures, making a developer's choice roughly equal in deciding between the two alternatives. However, by eliminating the use of IDB financing where the rehabilitation credit is claimed, it gives new construction a decided advantage. All building construction should have equal access to IDB financing. In addition, however, the rehabilitation credit is necessary to promote the reuse of old and historic buildings. H.R. 3110 would have the unintended effect of creating disincentives for rehabilitation and may even encourage the demolition of old and historic buildings. Unfortunately, if only one of these incentives is allowed, it is not unreasonable to expect developers to choose to raze older or historic buildings or, in the alternative, acquire undeveloped land and construct a new buildings using IDB financing. A comparative financial analysis illustrates this point:

Example 1

Purchase Land & Building	$ 300,000
Rehabilitation Expenditures (15,000 s.f.)	700,000
Total Development Cost	$1,000,000
Conventional Debt at 12.5% for 25 years (total payments $2,638,869)	$ 800,000
Equity	200,000
Total Source of Funds	$1,000,000
Available Rehabilitation Credit	
Assuming 25% credit	$ 175,000
Assuming 20% credit	$ 140,000
Assuming 15% credit	$ 105,000

Example 2

Purchase Land (with or without building)	$ 300,000
New Construction (15,000 s.f.)	700,000
Total Development Cost	$1,000,000
IDB Debt at 10.5% for 25 years (total payments $2,288,580)	$ 800,000
Equity	200,000
Total Source of Funds	$1,000,000
Savings in Debt Service	$ 350,282

These examples illustrate the effect of the higher interest rate of conventional debt. By saving approximately two percentage points on interest using an IDB, this developer will save over $350,000 in debt service over the life of a twenty-five year IDB, twice as much as the amount of the largest credit, and three and one-third times greater than the smallest credit. The renovated building in Example 1 will have a debt service cost of approximately $7.05 per foot and, when added to operating expenses of approximately $4.00 per foot (estimated average), requires the building to lease for at least $11.05 per foot in order to make the project feasible and not operate at a negative cash flow. In Example 2, the debt service cost per square foot drops to $6.10 per foot and, when added to operating expenses of $3.75 per foot (estimated average), will allow the building to operate at a rent of $9.85 per foot. This difference of $1.20 per foot in today's highly competitive market would be significant in deciding to build new construction with IDB financing rather than to rehabilitate an older building where, even with the rehabilitation credit, financing and operating costs are much more expensive.

These examples, while valid, are relatively uncomplicated to illustrate my point. However, as one who is involved professionally in equity financing of real estate, there is no question that many building renovation projects are not economically feasible or financially attractive without the combined use of the rehabilitation credit and IDB financing. In my professional opinion, the enactment of this bill will have a serious negative impact on the continued reuse of old and historic structures.

Under the provisions of H.R. 3110 developers considering the renovation of an old or historic buildings may consider electing against claiming the rehabilitation credit in lieu of IDB financing. In considering such an alternative a developer is no better off than if he chose new construction, but must still contend with the greater risk of cost over-runs during construction and space inefficiencies and higher operating costs created by the design of old buildings. That being the case, absent the incentive of the rehabilitation credit, developers are still likely to opt for new construction. In spite of this, if developers elect to use IDB financing in lieu of the rehabilitation tax credit, there will be no oversite as to the quality of the renovations at either the local, state or the Department of the Interior levels, as is presently required to qualify for the rehabilitation credit. Without this design review, many buildings may be permanently damaged by well intentioned, but uninformed or misguided, developers.

The use of IDB's to finance the rehabilitation of buildings is also often necessary in order to induce mortgage lenders to make loans on buildings which are often dilapidated and located in a blighted or depressed areas. Clearly, in this situation the combination of the rehabilitation credit and availability of IDB's is necessary to attract both developers and mortgage lenders.

In Louisville, the combined availability of IDB financing and the rehabilitation credit has been one principal reason for the economic redevelopment of the Central Business District and its surrounding neighborhoods. I refer you to the attached letters addressed to this Committee from the Mayor of Louisville, the County Judge/Executive of Jefferson County, Louisville Central Area, Inc., and Preservation Alliance of Louisville and Jefferson County, Inc. attesting to the economic and social impact that these incentives have had in Louisville. Since 1979, over $104 million has been committed by private developers to the rehabilitation of old and historic buildings in Louisville using both the rehabilitation credit and IDB financing. Of that amount, $87.4 million has been committed since 1981. This development has greatly enhanced the tax base for City and County property tax revenues and created jobs in the local economy at a time of national recession and higher than average local unemployment. A sampling of data on a state-wide basis indicates that currently in progress or just completed outside of Louisville and Jefferson County are an additional $14 milion worth of projects utilizing the rehabilitation credit in combination with IDB financing. In 1982, Kentucky ranked 6th nationally with 126 applications for projects utilizing the twenty-five percent credit for historic rehabilitation. So far in 1983 there have been 55 additional applications filed.

As the figures indicate, the longer than average lead time required in the planning and development of a rehabilitation project means we are just now beginning to see the positive results of these incentives as projects come on line. Unfortunately, approximately $81 million of present rehabilitation activity in Louisville will be adversely affected immediately by the enactment of this bill. There are many other renovations of which we are not yet aware that are being planned in reliance on the present tax structure and that will be adversely impacted or possibly terminated if H.R. 3110 is becomes law.

The use of both the rehabilitation credit and IDB financing has created incentives that have worked. The private sector is involved as it never has been before in the rehabilitation of old and historic buildings. This Committee should consider the wisdom of changing a tax policy that does what it is designed to do. In 1982, Kentucky's General Assembly amended Kentucky's industrial revenue bond statute in order to eliminate some perceived abuses. However, recognizing the importance of rehabilitations to the economic and social well-being of the Commonwealth, the amendment specifically added a provision for the use of industrial revenue bonds in cases of rehabilitation of buildings located in business districts and historic districts.

In evaluating whether there is a Federal revenue loss as a result of the combined use of the rehabilitation credit and IDB financing, this Committee should also consider the increased revenues from income taxes. While preserving the quality of the environment and our heritage, encouraging rehabilitations is sound economic policy. This economic activity generates income taxes paid by laborers and craftsmen (renovations are 40% more labor intensive than new construction), business income taxes on profits by suppliers of construction material, taxes from the income these buildings generate and taxes on the gain from the sale of these properties at a greatly appreciated value. It also assists local governments in becoming more self-sufficient by substantially increasing the tax base upon which they derive much of their tax revenues. When all of the tax revenues that are generated by this activity are taken into account, it is unlikely that there is any net revenue loss to the Treasury, but in fact a substantial net revenue gain which, but for the combined incentives, would not be generated.

II. Many of the Old and Historic Buildings Presently Owned by Tax-Exempt Entities Will Not Be Rehabilitated if Sale-Leaseback Financing Is Modified as Proposed by H.R. 3110.

H.R. 3110 would make sale-leaseback financing by tax-exempt organizations so unattractive as to effectively eliminate its use as a viable means of financing the restoration of old and historic structures that are owned by these organizations. Tax-exempts, such as municipal and county governments, libraries, colleges, universities and non-profit corporations, serve the public interest. These organizations own many old and historically significant buildings, yet as a rule do not have the financial resources to properly restore and renovate them. Instead, often the tax-exempt organizations that own these buildings are fortunate if they can afford minimal maintenance. This bill will effectively deprive many of these tax-exempt entities of the only way that they can afford to save these buildings by denying taxpayers who would otherwise enter into sale-leasback transactions of the deprecation deductions available in alternative real estate investments and denying the tax-exempt entity of the lower lease rate derived from tax-exempt financing.

A sale-leaseback transaction between a tax-exempt entity and a taxpayer using the rehabilitation credit and tax-exempt financing can save as much as thirty-three percent of the financing cost of issuing state or municipal bonds for the total project cost. In the case of an old or historic building, the taxpayer takes title to the building and contributes up to twenty-five percent of the rehabilitation cost by the off-setting use of the rehabilitation credit. The remaining rehabilitation expense is financed with tax-exempt financing. The rehabilitated building is leased back to the tax-exempt entity on a 20 year net lease wherein the tax-exempt's lease payment services the debt. Since tax-exempt financing is used, the lease cost to the tax-exempt organization is much lower. For example, the long-term tax-exempt interest rate on either municipal or industrial development bonds is approximately 10.5% in today's market. On a $1 million rehabilitation, a tax-exempt entity will save over $607,000 using sale-leaseback financing which is presently allowed, a savings of over thirty-three percent in financing costs.

Critics of sale-leaseback financing do not take into account that the taxpayer will pay taxes after fifteen years, if not sooner, when the available depreciation deductions are exhausted and on the gain from the disposition of the building at the end of the lease term. On the other hand, if a tax-exempt entity owned the building, such taxes would never be paid. Since present regulations under the Internal Revenue Code already prohibit the gifting of the building back to the tax-exempt entity at the expiration of the lease term, in all cases the Treasury will realize tax revenues from these transactions.

All of the positive economic and social impacts of historic renovations by the private sector apply in this area as well. When old and historic buildings are renovated in public-private ventures using the sale-leaseback method of financing, dollars are introduced into the economy, many jobs are created that otherwise would not have been and much of our heritage is saved for future generations.

In addition, it is axiomatic that tax incentives are more efficient and less costly to the Federal Treasury than Federal grants through transfer payments which might otherwise be used to help tax-exempts finance these renovations. The rehabilitation credit is a item of tax preference, therefore it is in all cases subject to a ten to twenty percent alternative minimum tax. If government transfer payments incur an estimated fifteen percent administrative cost, a $250,000 incentive costs the Treasury no more than $225,000 when the rehabilitation credit is used but cost approximately $287,500 when a transfer payment is made directly to a tax-exempt. The use of the transfer payment is at least twenty-eight percent more costly than is the direct incentive provided by the rehabilitation credit.

The sale-leaseback method of financing is the only way which many of our older and historic buildings which are owned by local governments and non-profit organizations can be saved and at a lower cost to these tax-exempts and the Federal government. Therefore, H.R. 3110(a) and (c) should exempt sale-leaseback transactions involving the rehabilitation of old and historic buildings.

III. H.R. 3110 Would Unfairly Deprive Taxpayers of Tax Incentives and Economic Benefits That They Have Relied Upon in Undertaking Renovations That Are Presently Under Development.

While its passage is unwise, should H.R. 3110 be enacted, the transition rule in sub-section d(1) is inadequate to protect projects already under development in reliance on the incentives provided by the rehabilitation credit and IDB financing. As stated earlier, there are approximately $81 million worth of renovation projects in Jefferson County alone which will be adversely affected by this legislation. Since the bill only exempts buildings "placed in service" on or before May 23, 1983, it would unfairly deny anticipated tax and economic benefits to those renovations which are nearing completion but have not yet been placed in service. As there is considerable debate even within the Internal Revenue Service as to when a project is placed in service for proposes of the rehabilitation credit, using this as a threshold for the transition rule only creates more uncertainty and clouds the availability of either incentive. Since the lead time for development of a rehabilitation project is much longer than is necessary for new construction, any transition rule must take this into account. Such a transition rule should, at the least, exempt all projects that as of some reasonable future date have an application pending for IDB financing or an application pending before local, state or Interior Department officials for rehabilitation credit approval.

CONCLUSION

In summary, H.R. 3110 should not be enacted because of the adverse effect this bill would have on this country's expressed national policy of protecting its older and historic buildings and encouraging their rehabilitation. The combined impacts of the prohibition against the use of IDB financing, the sale-leaseback disincentives, and, in all cases, inadequate transition rules, will put an end to the emerging trend in this country to rehabilitate and adaptively reuse our older buildings in both the private and public sector. It will deprive Americans of our touchstones of the past as well as the economic benefits that their rehabilitation creates by discouraging their rehabilitation, if not encouraging their demolition, and jeopardizing those renovations that are presently in under development in reliance upon present tax law. This Committee is urged not to adopt this bill and to allow the incentives that are finally beginning to work to remain a part of the tax policy of this country.

1778

HARVEY I. SLOANE
MAYOR

City of Louisville
Kentucky

Office of the Mayor

June 6th, 1983

UNITED STATES HOUSE OF REPRESENTATIVES
Ways and Means Committee
Washington, D.C.

RE: HR 3110

Dear Members of the Ways and Means Committee:

Louisville, Kentucky is having the greatest downtown renovation and construction boom in our history. This is happening because we are finding effective ways of combining public and private sector resources, and because we are using public incentives to stimulate and leverage private investment. In addition to major new construction in Downtown Louisville, we have had tremendous adaptive re-use of older buildings. The combination of industrial revenue bonds and investment tax credits has worked well in attracting private investment in our Downtown. At the present time $100 million in Industrial Revenue Boards are now committed in support of rehabilitation projects within the city. Of this $100 million, $65 million represents projects that are not fully completed and would be in serious jeopardy considering that the effective date of HR 3110 is May 23rd, 1983.

HR 3110 forces the enterpreneur to elect which mechanism he wishes to use: either IRB or ITC. The use of the two in conjunction is not double-dipping, but is a needed packaging mechanism.

By forcing the enterpreneur to look twice at possible projects in the older areas of the city the legislation in effect makes the construction of new projects in suburban areas more attractive. This is a definite problem which will reverse the present level of investment in urban areas and lead this city and others towards an investment flight back to the suburbs. It must be noted that by reducing the investment incentives, urban areas will be forced to create replacement incentives which will surely increase the need for federal assistance in the form of higher appropriations for CDBG monies, EDA monies, etc.

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UNITED STATES HOUSE OF REPRESENTATIVES
Ways and Means Committee
Washington D.C.
Page Two

HR 3110 is, in effect, squelching the incentives to do business which are needed to bring about a true and long lasting economic recovery. We urge your best efforts in defeating this legislation.

Sincerely,

Harvey Sloane
HARVEY I. SLOANE
MAYOR
CITY OF LOUISVILLE

HIS/sy

Mitch McConnell, County Judge/Executive

Office of the County Judge/Executive
Jefferson County Courthouse · Louisville, Kentucky 40202 · 502/581-6161

June 6, 1983

Dear Members of the House of Representatives - Ways and Means Committee:

This letter is to make you aware of my concerns regarding certain aspects of HB 3110. The areas I am particularly concerned about are in regard to incentives relating to the renovation and use of historic buildings. In Jefferson County we have seen the use of Industrial Revenue Bonds coupled with the Investment Tax Credit generate a substantial number of renovation projects. In Kentucky there was an investment of $50 million in 1982 of projects utilizing the Investment Tax Credit, a significant percentage of these also used Industrial Revenue Bonds. This investment translates into jobs, higher property taxes, higher occupational taxes and other tax increases, while revitalizing communities. I urge you to allow the continuance of the combined use of the Investment Tax Credit with Industrial Revenue Bonds. In addition, I urge you to continue the Sale-Lease back depreciation as it now stands in relation to 15 year old property, especially in the area of historic rehabilitation.

Please consider the full implications of change to the tax structure, relating to historic structures. The current legislation has had a very positive effect on the economic revitalization of our county.

Sincerely,

Mitch McConnell

Mitch McConnell
County Judge/Executive

MM:EFPJ:ts

LCA

LCA is the non-profit organization formed in 1959 to spearhead the revitalization of Downtown Louisville. LCA brings together businesses, individuals, property owners, institutions and government in an organized program to make Downtown strong, healthy and attractive.

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SPECIAL PROGRAMS
Barbara P. Hancock

June 3, 1983

Ways and Means Committee
United States House of Representatives
Washington, D. C.

RE: HR 3110

Honorable Members of Congress:

We are the private sector, non-profit organization which works in partnership with local governments to revitalize the heart of Louisville.

Urban decay and the resulting breakdown in physical, financial, governmental and social structures are among America's most critical domestic economic problems. It is obvious that government alone cannot revive our cities and make them viable, productive and self-sufficient. However, in Louisville, we are experiencing unprecedented success in joint public-private efforts in which public monies and incentives are judiciously used to stimulate private investment.

To illustrate the specific results of our public-private teamwork, between 1971 and 1978 we increased our Downtown tax base from $210 million of assessed value to $310 million, a 48% increase. From 1979 to 1985, we will increase it from $310 million to $680 million, a 120% increase during a period of severe economic recession in Louisville. The success of this revitalization is that we have had a combination of new construction, well-mixed with major adaptive re-use and and renovation of older buildings. The tools which have made this adaptive re-use possible are the combination of industrial revenue bond financing and investment tax credits to private developers.

Since the reduction of Federal funding of urban programs is shifting the responsibility back to local governments, and encouraging private investment to build our cities, create jobs and move America forward (and rightfully so, in our opinion), we feel that it would be a mistake to reduce or impair private investment by altering the present industrial revenue bond and investment tax credit incentives. We therefore urge your favorable action in the continuation of these important programs for the revitalization of American cities.

THANK YOU.

Sincerely,
Robt W. Bivens
Robert W. Bivens
President

Louisville Central Area, Inc. • 555 Brown & Williamson Tower • Louisville, Kentucky 40202 • (502) 583-1671

Preservation Alliance
of Louisville and Jefferson County, Inc.

David L. Brook
Executive Director

Donald J. Weber, N.C.A.R.B.
Assistant Director for
Development & Planning

Terry G. Knox
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Richard L. O'Malley
R. Jeffrey Points
Sharon Potter
Thomas Schuster
Alexander Speer
James W. Stites, Jr.

June 6, 1983

Mr. Robert B. Vice
Chairman of the Board
Preservation Alliance
716 West Main Street
Louisville, Ky. 40202

Dear Mr. Vice:

I am writing this letter in order to express my concern over recent proposals in Congress that would diminish or remove tax advantages associated with the rehabilitation of older buildings. Specifically, I understand that current proposals before the House Ways and Means Committee of the U.S. House of Representatives would prohibit the combined use of investment tax credits (ITC) and governmental bonds for development. I further understand that private developers would not be permitted to enter intc sale-leaseback arrangements with private nonprofit or governmental organizations.

The use of the ITC and bonds has been a primary catalyst for renovation and rehabilitation in Louisville. Furthermore, sale-leaseback arrangements have also spurred much economic activity. A prospective headquarters development plan for the Preservation Allinace contemplates a sale-leaseback arrangement involving a private developer. I, therefore, urge that these proposals be defeated or severely modified.

Given the high unemployment rate in Louisville and our loss of population and jobs, the existence of the construction rehabilitation industry that has flourished in Louisville is of crucial importance. The use of incentives such as bonds and the ITC has made the industry possible. The benefits are profound in light of the labor intensive quality of rehabilitation projects.

Along this line, I direct your attention to the following statistics:

(1) The U.S. Department of Commerce has estimated

716 West Main Street • Louisville, Kentucky 40202 • 502 583-8622

that one million dollars spent on preservation projects creates an average of 109 jobs, compared with an average of 69 jobs for new construction.

(2) The October, 1977 issue of 11593, a publication of the Technical Preservation Services branch of the Department of the Interior, states that, "... rehabilitation projects are heavily labor intensive, often 75% of the dollars expended are for labor costs. New construction is usually about 50% labor and 50% materials. That means for money invested in rehabilitation, the greatest part of it goes directly into the local economy to support commerce and increase employment."

This constitutes a great national benefit, particularly when combined with other positive attributes of preservation construction cited by the Interior Department in 11593:

- general revitalization of the city
- increased property tax base and revenues
- support for the commercial business segment
- re-creation of community/neighborhood feelings in urban centers
- reduction of energy outlay resulting from fewer commuting workers
- increased use of neglected utility systems
- feelings of identity and pride of ownership

For these reasons, alterations of existing preservation incentives under tax and bond law will have unfortunate effects for our national heritage and construction industry. Efforts to modify or destroy these incentives in this time of economic hardship must be defeated.

Sincerely,

David L. Brook

David L. Brook
Executive Director

DLB/ms

Mr. **Pickle**. Have we received testimony now from everybody on the panel? We had a vote that intervened right in the middle of this, and a member, who we knew had testimony had to leave.

I thank you for testifying. I have to assume that based on the testimony I have heard, that all of you want to change the provision in the housing section, section 1(c). You basically want rehab credits as well as IDB's, I presume. As a principle, you want the IDB financed.

Is that the sense of what you are asking for?

Mr. **Schochet**. Yes, sir.

Mr. **Schreiberg**. I think there is a slight difference among us in that most of us are saying that, as explained in your written statements and in your explanation of the bill in the Record when you offered the legislation, and again in Chairman Rostenkowski's explanation, it is indicated that a developer in the nonsale/leaseback situation does not have to choose between the investment tax credits and the IDB's, but when we looked at the actual language of the bill that is not the way it came out and that is our concern, what I think we all share, that at a minimum that ambiguity be clarified. And if you decide to retain this language, you need a transition rule which is different than we have been talking about this morning, which I think all of us have suggested.

Mr. **Pickle**. Well, in addition to wanting the IDB's, you want a transition phase?

Mr. **Vice**. Well, if you exempt out or clarify the effect of this bill so that it does not cover private sector redevelopment activity where tax exempts are not involved, where both the rehab credit and IDB financing is used, then we don't need a transition rule because that obviously wouldn't be covered by this bill. However, on a worst case basis, if this bill does intend to address the use of both IDB financing and ITC by private sector developers in non-tax-exempt transactions, then there should be adequate protection for the many, many projects. In our city alone, there is over $87 million in projects that would be affected right now.

Mr. **Pickle**. Now that means, in effect—and I don't see it as critical, but if I am correct in my analysis, if you get all these credits then you will get, in many instances, the full 25-percent rehab credit.

Mr. **Vice**. Yes, sir.

Mr. **Pickle**. Plus you will get the percentage on the IDB's and/or the ACRS and, in some cases, both.

Mr. **Vice**. That is correct.

Mr. **Pickle**. And you will get the deduction on interest.

Mr. **Vice**. That is correct.

Mr. **Pickle**. Now, that means then that in most projects that you would classify as rehabilitation, that would be an approximate 25- to 40-percent tax credit on a given project.

Mr. **Vice**. Well, there is only a 25-percent tax credit. There are other tax incentives, obviously——

Mr. **Pickle**. I am talking about tax rehab plus the ACRS and IDB financing and interest.

So you go up as much as 47 percent, roughly. So on any given project that you want to produce for the good of the public to make you and the churches and the people and God and everybody happy, and you spend $1 million on it or $10 million—let's say $10 million—and that is what a lot of these projects amount to, $10 million, then 40 percent of that would be financed by the Federal Government.

We lose that revenue; that is a basic fact. Is it not? So that is why you want to retain it—and I can understand why you would—the IDB and financing and these other aspects of it. But when you add it up together, it is a good, sweet deal for you locally and it is a better deal for the financing people.

These bond houses, they are more active in the sale of these leases than a popcorn salesman is at a football game. But the Federal Government is having to finance all this.

Mr. ADLER. Mr. Pickle, if I may say so, most of these dealings were not being done so the 80 percent that comes in, at least you are getting buildings in commercial areas in blighted inner-city housing areas done that were not being done before.

Mr. PICKLE. Mr. Adler, let me say you are correct. I think there is a definite purpose served by the rehabilitation aspect of restoration. I would defend it with you. I think probably it would help restore old sections as much as any one program. The question is, how rich do you want to make it?

Mr. ADLER. Well, the question was, though, that before you could not get it done without both of them because you are overcoming situations that have been neglected for so long, that these buildings will either fall down or there will be the gentrification in inner-city housing that we are trying to perform.

Mr. PICKLE. But the bill does not cut it out. The bill says you either get ACRS or the rehab, but not both.

Mr. ADLER. We are testifying that both were needed to get it done. I am not personally on a sale/leaseback situation. I can understand there are certain cases where there have been abuses. I have not seen abuses in the city of Savannah or the city of Louisville, and other cities using IRB's in connection with the tax credit to revitalize the inner cities that we have been trying to do for years.

Mr. PICKLE. When we introduced the bill, we did not want to knock out of our restoration program the use of rehab programs. We think it served that purpose. But we also say, how much can you give to this? And if we do give both, then we have to ask you, as a matter of policy, can we, the Federal Government—you can avoid it because you are getting it; you want it—now the question is, can we, the Federal Government, with a $200 million deficit—and it was estimated this morning that that can double within the next 5 years just by the use of the lease sales alone—then how far do we go? And, frankly, we don't know that. It is a policy decision we have got to make.

Mr. ADLER. Because it has gone as far as it has, it has accomplished miracles in places where there was no hope.

Mr. PICKLE. What does it accomplish for the Federal Government?

Mr. ADLER. It has gotten property back on the tax rolls. It has had businesses paying taxes in inner cities, Federal taxes, State taxes, and local taxes.

Mr. Pickle. Well, in some cases they are not taxed. Some of them are taxed and some of them are not.

Mr. Adler. Most of this has been done for profit.

Mr. Pickle. Here again, that is a policy question the Government has got to decide. Can we afford it? If we had the money or the funds, I don't think we would be looking this closely. But we have to ask who is going to pay for it in the long run.

Now, let me ask a question to each one of you, because this is the question the chairman wanted to ask the group.

If this committee limited the IDB's and the rehab credits to situations where the use is by nonprofit or governmental units, like the rest of the bill, would that solve most of your problem?

Mr. Schreiberg. That is exactly the point that at least our group is seeking to make. We agree there are abuses.

Mr. Pickle. I am not trying to nail you to the situation.

Mr. Schreiberg. We want to be nailed to it.

Mr. Pickle. In general, this would satisfy you?

Mr. Schochet. Yes, sir.

Mr. Vice. Within the parameters of testimony by Treasury this morning.

Mr. Pickle. And what effective date do you want it?

Mr. Schreiberg. Well, the concern that we have—and I do intend this to be flattering—when a gentleman such as yourself, from where you sit on the committee makes the public statement and introduces the bill, as you have, you have created a total chill right now where no reputable tax or bond counsel who will enter an opinion without a statement by you literally on the record that you at least looked for a transition rule.

We have suggested one solution to staff which would be the passage of an inducement resolution by an issuing governmental authority as of the date of May 23. We think that is a fairly restrictive rule. We may disagree among ourselves on that. That is one suggestion we have made to your staff.

Mr. Pickle. Mr. Edson, are you an attorney?

Mr. Schreiberg. I am Mr. Schreiberg.

Yes, sir.

Mr. Pickle. I figured you must be an attorney because when you got to the point about what date you want, your voice trailed off and I never heard it. Give me a date now so I can understand you.

Mr. Schreiberg. The transition rule that we have suggested is based on the fact that the May 23 date in itself is not necessarily harmful. The question is, what action had to be taken by that date, and we had suggested the passage of an inducement resolution by issuing authority as of that date as one test that you might consider.

Mr. Pickle. You want something besides a binding contract.

Mr. Schochet. Mr. Pickle, the contract to purchase the bonds occurs maybe 2 days before the closing on the bonds takes place. I am in a position right now, as an example, where I have a project ready to go in Los Angeles that has gone through about eight layers of governmental approval. I expect it to close on June 30. And because there is no transitional rule being discussed, at least in public, by this committee, I am stopped from moving forward.

This is not a sale/leaseback. This is a building which is a historic building in downtown Los Angeles. I can't start because my counsel will not give me a tax opinion.

Mr. **Pickle**. Sir, I recognize that the introduction of this bill may have stopped a lot of projects that were well intended and has recently gotten all the parties concerned worked up to a real white heat. I can understand that. But we did not know the depth of the practice that is underway, not just in the rehab but in the sale/leaseback programs as we have discovered since we introduced this legislation, because we have heard from all sections of the United States saying, first, we agree with you in this legislation; it is right. It has got to be stopped.

But I have got a project in my city of Los Angeles or St. Paul or Austin, Tex., or wherever it may be, and we know those are real situations. Now, we have got to try to take those facts under consideration, but I can't say we can do any more at this point than just operate at this point from the basis of the bill that is introduced.

But I appreciate your testimony, and I am not going to ask you any more questions. At least I know what you would agree to. Whether you get that is something else, but I know what you would be satisfied with.

Any other members?

Mr. **Duncan**. No questions. Thank you.

Mr. **Pickle**. I thank you all for your testimony.

The next panel consists of the National Conference of Black Mayors, Ms. Michelle Kourouma; and then the Municipal Finance Officers Association, Catherine Spain; and then the American Federation of State, County and Municipal Employees, Mr. Bill Welsh.

STATEMENT OF MICHELLE D. KOUROUMA, EXECUTIVE DIRECTOR, NATIONAL CONFERENCE OF BLACK MAYORS, ACCOMPANIED BY GILL HARDY AND RICK GROSS, COUNSELS

Mr. **Pickle**. Michelle Kourouma, do you have a prepared statement?

Ms. **Kourouma**. Yes; I do. I am Michelle Kourouma.

Mr. **Pickle**. Suspend just a minute while I get your testimony, so I can follow you.

Please proceed.

Ms. **Kourouma**. I am Michelle Kourouma, often referred to as Mr. Kourouma. It is not the first time, I am afraid to say.

I am the executive director of the National Conference of Black Mayors, Inc., and I am here with our legal counsel, Mr. Gill Hardy and Mr. Rick Gross who are with the law firm of Wald Harkrader & Ross.

I am here today on behalf of the Honorable Johnny Ford, the mayor of Tuskegee, Ala., and the president of the National Conference of Black Mayors. I am going to deliver this statement on behalf of the organization.

The National Conference of Black Mayors is a nonprofit, nonpartisan service organization formed expressly to assist black mayors in defining their problems and identifying sources of funds that could be utilized in improving the social and economic conditions of their constituents. While American cities have characteristically suffered from neglect, the situation of many communities headed by recently elected black mayors is even more acute.

Historically, black people, in elective or individual capacities, have had little access to the decisionmaking process and little ability to influence the dispersal of funds to insure the provision of needed goods and services, as well as employment opportunities. Many of the black mayors that are elected to public office are inheriting poorly functioning governments with no formal budgets and crippling deficits. They are also finding few resources to deal with fundamental problems in the areas of housing, water, sewage, health, education, employment, and community-industrial development.

The conference has sought to assist its members, consisting of 226 mayors representing over 10 million people, in solving the numerous problems associated with municipal management, growth and development.

Most of our cities are in desperate shape. Businesses which provide needed jobs and tax revenues are increasingly seeking suburban locations. Without adequate employment and tax revenues, increased funds must be diverted to social services.

The cities' services and equipment deteriorate further, accelerating the pace of business relocation. The cycle feeds on itself with increasing velocity. We are left with decaying, poor, largely minority, inner-city core. In the face of decreased Federal funding, the urban population is left with few resources and little hope to reverse this trend.

In response to these painful realities, cities have tried to attract investment capital. The concepts of enterprise zones, tax-based financing, and other public/private partnerships are being used with modest success. But the needs are great and all available tools have to be marshaled to close the funding gap. Equity syndication and leaseback of public property is just such a tool.

The equity syndication and leaseback approach involves tax incentives available to other entities. But just as we have begun to make use of this concept to help revitalize our cities, H.R. 3110 has been introduced to snatch it away. Mr. Chairman, we are opposed to this bill, just as we would be to any attempt to shut off the means to save our cities.

The typical sale and leaseback arrangement used by cities involves no unusual techniques. A city will sell its property to a syndicate of investors for capital it critically needs. If, in a given transaction, there are economic losses, the investors will bear the economic burden of those losses.

The syndicate will own the property, at its own risk. As owners, the investors will be able to claim all the normal benefits of property ownership, including deductions for expenses and depreciation. Of course, the city will have to pay rent on the property. In short, these transactions involve real economic considerations.

Such arrangements, when economically justified, offer some hope to depressed cities. If they can capture the unused wealth in the plant and equipment already paid for by their citizens, then perhaps the cities can rebuild or refurbish older, decaying property and revitalize their own economies.

With new funds available from sale-leasebacks, our cities can put people back to work, increase the tax base, improve public services, and refurbish or replace neglected facilities. Mr. Chairman, we must offer our cities some hope for real recovery. Perhaps this vehicle can help break the vicious cycle spawned by years of neglect.

All of these needs are intensely felt in the cities goverened by black mayors. If urban America is poor, statistics demonstrate quite dramatically that black urban America is even poorer. Our cities need the most help, and our people need the most hope.

Mr. PICKLE. Let me interrupt you. I did not make it plain to you that we were asking the panelists to limit the comments to a 5-minute period. I did not make that plain. I don't want to cut off your testimony. I ask you to try to summarize, and the other panelists, to stay with their limitations. We have about 25 witnesses this afternoon we want to hear.

Mostly, we want to get your testimony on the record. If you would proceed as quickly as you can. I am sorry I didn't make that plain.

Ms. KOUROUMA. Then I would like to continue, and I will cut it short.

Support for H.R. 3110 is based largely on the misconception that cities and nonprofit organizations want to use abusive arrangements similar to the Navy's plan to sell tax benefits on ships. What our cities are contemplating is what they, as well as profitmaking corporations and other property users, have always done—continually evaluate the choice of owning or leasing property and equipment. Such arrangements have been contemplated by the Internal Revenue Code and approved by the courts well before the adoption of ACRS.

The Navy's plan is dramatically different from legitimate leasing arrangements by nonprofits and State and local governments because that plan was specifically designed to separate tax benefits from economic risks. In fact, the Navy's scheme guaranteed the investors against both economic and legal risks. Thus, the so-called investors did not assume real economic risks of loss or gain.

In contrast, when a city leases a computer system, office building, or other asset, it is shifting the economic risks and rewards to the investor-owners. Like any entity with capital needs, that is one important reason it decides to lease rather than own.

The private, tax-paying owner's investment in property used by a tax-exempt is no safer from fire, decreasing value, or technological obsolescence than if the property were leased to a bank or a major oil company. Indeed, given the current financial weakness of many local governments, it is often riskier to lease to a city than to a profitmaking company.

The 1981 tax law did not change the basic sale-leaseback technique, but by accelerating tax depreciation schedules, it increased the rewards of owning property. As a result, increased investment has been drawn into new and existing capital assets. In the last 2 years, private owners of real property have raised significant sums through the sale of their property—now worth substantially more to new investors as a result of the tax law changes.

Leasing by cities is identical to leasing by private corporations. Both are lowering their costs or raising cash by shifting the economic risks and rewards of ownership to investors. If that is legitimate for the private sector, it certainly is legitimate for the city of Tuskegee, whose needs are greater and whose assets are wholly dedicated to public purposes.

I would like to end by saying as Congress considers changes in the 1981 tax law, we suggest that it should not do so on a piecemeal and discriminatory basis. Members must decide how serious they were, and are, about supporting productive investment. Rather than discriminating against our cities, Congress should help to rebuild them by encouraging these highly productive partnerships.

With all due respect, the National Conference of Black Mayors urges the committee to reject H.R. 3110.

[The prepared statement follows:]

STATEMENT OF MICHELLE D. KOUROUMA ON BEHALF OF HON. JOHNNY FORD, PRESIDENT, NATIONAL CONFERENCE OF BLACK MAYORS

I am Michelle D. Kourouma, Executive Director of the National Conference of Black Mayors, and I am here today on behalf of Hon. Johnny Ford, the Mayor of Tuskegee, Alabama and the President of the Conference, to deliver this statement on behalf of the Conference. The National Conference of Black Mayors is a nonprofit, nonpartisan, service organization formed expressly to assist black mayors in defining their problems and identifying sources of funds that could be utilized in improving the social and economic conditions of their constituents. While American cities have characteristically suffered from neglect, the situation of many communities headed by recently elected black mayors is even more acute.

Historically, black people, in elective or individual capacities, have had little access to the decision-making process, and little ability to influence the dispersal of funds to insure the provision of needed goods and services, as well as employment opportunities. Many of the black mayors that are elected to public office are inheriting poorly functioning governments with no formal budgets and crippling deficits. They are also finding few resources to deal with fundamental problems in the areas of housing, water, sewage, health, education, employment, and community-industrial development.

The Conference has sought to assist its members, consisting of 226 mayors representing over 10 million people, in solving the numerous problems associated with municipal management, growth and development.

Most of our cities are in desperate shape. Businesses which provide needed jobs and tax revenues are increasingly seeking suburban locations. Without adequate employment and tax revenues, increased funds must be diverted to social services. The cities' services and equipment deteriorate further, accelerating the pace of business relocation. The cycle feeds on itself with increasing velocity. We are left with a decaying, poor, largely minority, inner-city core. In the face of decreased federal funding, the urban population is left with few resources and little hope to reverse this trend.

In response to these painful realities, cities have tried to attract investment capital. The concepts of enterprise zones, tax-based financing and other public/private partnerships are being used with modest success. But the needs are great and all available tools have to be marshalled to close the funding gap. Equity syndication and leaseback of public property is just such a tool.

The equity syndication and leaseback approach involves tax incentives available to other entities. But just as we have begun to make use of this concept to help revitalize our cities, H.R. 3110 has been introduced to snatch it away. Mr. Chairman, we are opposed to this bill, just as we would be to any attempt to shut off the means to save our cities.

The typical sale and leaseback arrangement used by cities involves no unusual techniques. A city will sell its property to a syndicate of investors for capital it critically needs. If, in a given transaction, there are economic losses, the investors will bear the economic burden of those losses. The syndicate will own the property, at its own risk. As owners, the investors will be able to claim all the normal benefits of property ownership, including deductions for expenses and depreciation. Of course, the city will have to pay rent on the property. In short, these transactions involve real economic considerations.

Such arrangements, when economically justified, offer some hope to depressed cities. If they can capture the unused wealth in the plant and equipment already paid for by their citizens, then perhaps the cities can rebuild or refurbish older, decaying property and revitalize their own economies. With new funds available from sale/leasebacks, our cities can put people back to work, increase the tax base, improve public services and refurbish or replace neglected facilities. Mr. Chairman, we must offer our cities some hope for real recovery. Perhaps this vehicle can help break the vicious cycle spawned by years of neglect.

All of these needs are intensely felt in the cities governed by black mayors. If urban America is poor, statistics demonstrate quite dramatically that black urban America is even poorer. Our cities need the most help, and our people need the most hope.

Support for H.R. 3110 is based largely on the misconception that cities and nonprofit organizations want to use abusive arrangements similar to the Navy's plan to "sell" tax benefits on ships. What our cities are contemplating is what they, as well as profit-making corporations and other property users, have always done—continually evaluate the choice of owning or leasing particular property and equipment. Such arrangements have been contemplated by the Internal Revenue Code and approved by the courts well before the adoption of ACRS.

The Navy's plan is dramatically different from legitimate leasing arrangements by nonprofits and state and local governments because that plan was specifically designed to separate tax benefits from economic risks. In fact, the Navy's scheme guaranteed the "investors" against both economic and legal risks. Thus, the so-called "investors" did not assume real economic risks of loss or gain.

In contrast, when a city leases a computer system, office building or other asset, it is shifting the economic risks and rewards to the investor/owners. Like any entity with capital needs, that is one important reason it decides to lease rather then own. The private, tax-paying owner's investment in property used by a tax exempt is no safer from fire, decreasing value, or technological obsolescence than if the property were leased to a bank or a major oil company. Indeed, given the current financial weakness of many local governments, it is often riskier to lease to a city than to a profit-making company.

The 1981 tax law did not change the basic sale-leaseback technique, but by accelerating tax depreciation schedules it increased the rewards of owing property. As a result, increased investment has been drawn into new and existing capital assets. In the last two years, private owners of real property have raised significant sums through the sale of their property—now worth substantially more to new investors as a result of the tax law changes.

Leasing by cities is identical to leasing by private corporations. Both are lowering their costs or raising cash by shifting the economic risks and rewards of ownership to investors. If that is legitimate for the private sector, it certainly is legitimate for the City of Tuskegee, whose needs are greater and whose assets are wholly dedicated to public purposes.

Unfortunately, H.R. 3110 set up two sets of depreciation tables—a generous one (15 years or pre-1981 standards) for property used for private profit and a discriminatory one (35 years) for property used for public purposes.

Thus, for example, when two owners of high-rise office buildings want to realize the increased value of their property resulting from the 1981 tax law, they can sell their buildings to each other and both get the benefit of 15-year writeoffs. Such swaps apparently are legal and, in fact, have been done with increasing frequency. No new capital asset has been created. The productivity of the American economy remains unimproved. But Federal revenue has been reduced.

Yet, under H.R. 3110, buyers of property sold and leased back by cities seeking to pull cash out of properties identical to those of private corporations would be required to use a discriminatory 35-year tax life, even when the private corporation could use the highly beneficial 15-year life. As a result, the amount of cash realized from an ACRS building would be 57 percent less to the city than to the for-profit corporation.

This depression of the value of property used by cities is particularly ill-advised, since the cash raised by the cities in sale/leasebacks clearly must be used for public benefit purposes—infrastructure development, crime control, rehabilitation, and the rest. In sharp contrast, when for-profit owners pull cash out of existing capital assets, there is no requirement that the newly-acquired funds be used for any productive purpose.

Not only will this bill create two tax systems—one for the rich and one for everyone else—the bill also will intensify the severe competitive disadvantage of cities in the capital markets. Because the interest on corporate bonds is tax deductible to the issuers, while the interest on municipal bonds is merely tax exempt to the purchasers, the cost of capital to cities has always been higher than the cost to profit-making entities.

The discrimination against public capital investment was compounded by the 1981 tax law. In a recently released study by the Council of State Planning Agencies, former Citibank economist Roger J. Vaughn points out that "interest rates on tax exempt bonds have risen alarmingly" in the last few years. In fact, the differential between interest rates on taxable and tax exempt bonds dropped from 35 percent in 1979 to less than 20 percent in 1982. Much of this deterioration of the public sector's position in the capital markets, according to Vaughn, can be traced to recent changes in the federal tax law. These include "the reduction in the maximum tax rate from 70 percent to 50 percent, the creation of tax-exempt All Savers Certificates, and the expansion of tax-exempt bonds."

Vaughn also notes that the "expansion of leasing activities" by the private sector "has reduced the attraction of municipal bonds." The bottom line is that cities, always at a competitive disadvantage when seeking funds for capital projects, would be penalized further by H.R. 3110. While deep tax incentives would push investment toward for-profit users of property, tax exempt users of identical property would find their cost of capital again increased and the value of their existing assets depressed.

No one can argue that our country needs more productive investment. But we feel that investments in our cities—in our schools, water systems and buses—are just as critical to rebuilding America's economic strength as are investments in high tech R&D and retooling the auto industry, and far more important than the tax-motivated real estate transactions by for-profit owners that the bill would leave untouched.

Congress may conclude that the accelerated depreciation provisions enacted in 1981 are inefficient ways to subsidize capital investment. If so, those provisions should be cut across the board. It is difficult to see how accelerated depreciation and tax leasing are efficient when used by wealthy real estate speculators or profit-making corporations, but inefficient when used by struggling cities. To enact into law such a discriminatory distinction would clearly direct additional investment out of productivity-boosting projects into the kind of non-productive tax shelters that have proliferated since 1981.

As Congress considers changes in the 1981 tax law, we suggest that it should not do so on a piecemeal and discriminatory basis. Members must decide how serious they were, and are, about supporting productive investment. Rather than discriminating against our cities, Congress should help to rebuild them by encouraging these highly productive partnerships.

With all due respect, the National Conference of Black Mayors urges the Committee to reject H.R. 3110.

STATEMENT OF CATHERINE L. SPAIN, DIRECTOR, FEDERAL LIAISON CENTER, MUNICIPAL FINANCE OFFICERS ASSOCIATION, ACCOMPANIED BY JOHN E. PETERSEN, DIRECTOR, GOVERNMENT FINANCE RESEARCH CENTER

Mr. PICKLE. Ms. Spain?

Ms. SPAIN. Mr. Chairman, members of the committee, my name is Catherine Spain. I am director of the Municipal Finance Officers Association's [MFOA] Federal Liaison Center. With me is John E. Petersen, director of MFOA's research arm, the Government Finance Research Center. Dr. Petersen is here to answer questions you may have on the municipal bond market and other concerns you may have about State and local government capital financing. The Municipal Finance Officers Association represents 9,200 members who are State and local government finance officials, appointed or elected.

The subject of today's hearings, proposed restrictions on leasing by the Federal Government and other tax-exempt entities, has captured our attention because it restricts a new financing arrangement which is serving as an alternative to loans in the use or acquisition of capital assets by State and local governments. We are concerned that the proposal may restrict transactions which have real economic substance apart from tax considerations, and may limit experimentation in financing techniques and the provision of services at a time when experimentation is essential to find ways of reducing costs.

From the outset, let me make it clear that the Municipal Finance Officers Association has not yet developed a policy statement with regard to this form of financing. However, we have developed a body of knowledge on the subject of governmental leasing by State and local governments through the research activities of our Government Finance Research Center. I might add our members will be meeting in Toronto, Canada within 72 hours to consider a policy in this area.

We feel compelled to react to the legislation not because the Association is for or against the bill, but as practitioners and experts in public finance, we feel we have a responsibility to explain why and how creative financing techniques are used. Sale-leaseback financing has grown in use by State and local governments as a result of sharply curtailed Federal grant programs, changes in the Tax Code, and unfavorable conditions in the bond market. The technique allows for the reduction of the costs of public facility financing through the involvement of private investors.

In the literature, this appeal has been likened to that for industrial development bonds; but there is an important distinction to make: through industrial development bond financings, State and local governments assist private, taxable businesses by creating the convenient fiction that tax-exempt industrial development bonds have a fully public character. The same governments, through lease finance arrangements, mobilize Federal tax subsidies for a purely public project by depicting the project as a private, taxpaying entity.

The Municipal Finance Officers Association has testified before Congress on a number of occasions in opposition to the use of tax-exempt bonds that only benefit private industries and are not functions of State and local government. In adopting our policy against industrial development bonds, we carved out exceptions when the use of small-issue industrial development bonds might be acceptable.

We believe these bonds can be used as an effective economic development tool if they are restricted to areas of serious economic deprivation. Further, the association is not opposed to industrial development bonds if the public issuer remains associated both functionally and financially with the capital asset. We believe this to be the case in many of the sale-leaseback arrangements.

Although we have no specific policy covering the provision which would mandate straight-line depreciation for properties used by State and local governments and deny the more rapid writeoff of depreciation, we do have a number of concerns. In designing the investment tax credit, Congress provided that the subsidy was clearly and explicitly designed to be an investment stimulus to private business.

Depreciation, on the other hand, is merely a method of recovering capital costs and may be taken by any taxpayer with respect to property held for the production of income or in a business or trade. By imposing the use of an extended rather than an accelerated cost recovery system when the affected property is leased back by a governmental entity, the potential benefits of investment for public infrastructure and other public capital projects are reduced when compared to those for private investment.

In effect, the State-local sector is put at a competitive disadvantage in raising capital because the after-tax cost of capital investments by private corporations will be skewed to investments in nongovernmental areas.

In conversations with practitioners, several broad issues have emerged which we wish to highlight:

It has been suggested that the Congress is overreacting to a problem at the Federal level by restricting a practice at the State and local level it perceives to be out of hand. No data are available on sale-leaseback financings.

We have been asked whether the assignment of an effective date prior to the date of enactment is an appropriate way for the Congress to legislate. We believe that affected parties should be given an opportunity to comment on proposals prior to their implementation.

State and local officials are painfully aware of the massive infrastructure and economic development needs now so eloquently described in the growing volume of studies. They wonder where the money will come from to arrest deterioration and to develop needed new facilities in the face of Federal grant cutbacks.

In many localities, sewerage and waste disposal functions are performed by private entities under contracts with the local jurisdictions which may now be prohibited.

We remind you that the tax benefits associated with sale-leasebacks are being considered in a vacuum. For years after the period of depreciation ends and/or the investment tax credit has been taken, the effects on Federal revenues will be diminished as taxable income rises.

Technical questions that relate to definitions are also of concern. The phrases "short-term or casual leases" and prohibiting leases where investors are "protected from loss" could have adverse consequences, depending upon IRS or judicial interpretations of those concepts. Similar restrictions do not apply to private users, and they appear to be discriminatory here.

If Congress succeeds in passing this legislation, will the result be a successful operation, but a dead patient? Is it always wrong to finance public works with the assistance of private investment?

[The prepared statement follows:]

STATEMENT OF THE MUNICIPAL FINANCE OFFICERS ASSOCIATION

SUMMARY

Mr. Chairman and Members of the Committee, my name is Catherine L. Spain. I am Director of the Municipal Finance Officers Association's (MFOA) Federal Liaison Center. With me is John E. Petersen, Director of MFOA's research arm, the Government Finance Research Center. Dr. Petersen is here to answer questions you may have on the municipal bond market and other concerns you may have about State and local government capital financing. The Municipal Finance Officers Association represents 9,200 members who are State and local government finance officials, appointed or elected.

The subject of today's hearings—proposed restrictions on leasing by the Federal Government and other tax-exempt entities—has captured our attention because it restricts a new financing arrangement which is serving as an alternative to loans in the use or acquisition of capital assets by State and local governments. We are concerned that the proposal may restrict transactions, which have real economic substance apart from tax considerations, and may limit experimentation in financing techniques and the provision of services at a time when experimentation is essential to find ways of reducing costs.

From the outset let me make it clear that the Municipal Finance Officers Association has not yet developed a policy statement with regard to this form of financing. However, we have developed a body of knowledge on the subject of governmental leasing by State and local governments through the research activities of our Government Finance Research Center.

Sale-leaseback financing has grown in use by State and local governments as a result of sharply curtailed Federal grant programs, changes in the tax code, and unfavorable conditions in the bond market. The technique allows for the reduction of the costs of public facility financing through the involvement of private investors. In the literature, this appeal has been likened to that for industrial development bonds; but, there is an important distinction to make: Through industrial development bond financings, State and local government assist private, taxable businesses by creating the convenient fiction that tax-exempt industrial development bonds have a fully public character. The same governments, through lease finance arrangements, mobilize Federal tax subsidies for a purely public project by depicting the project as a private, taxpaying entity.

The Municipal Finance Officers Association has testified before Congress on a number of occasions in opposition to the use of tax-exempt bonds that only benefit private industries and are not functions of State and local government. In adopting our policy against industrial development bonds we carved out exceptions when the use of small-issue industrial development bonds might be acceptable. We believe these bonds can be used as an effective economic development tool if they are restricted to areas of serious economic deprivation. Further, the Association is not opposed to industrial development bonds if the public issuer remains associated both functionally and financially with the capital asset. We believe this to be the case in many of the sale-leaseback arrangements.

Our existing IDB policy leads us to question whether industrial development bond financing should be prohibited in those situations where the investment tax credit is taken by the lessor as provided by H.R. 3110. Our policy writers never envisioned the coupling of industrial development bond financing with municipal leasing and the applicability of investment tax credits so our criticism is reserved at this time.

Although we have no specific policy covering the provision which would mandate straight-line depreciation for properties used by state and local governments and deny the more rapid write-off of depreciation, we do have a number of concerns. In designing the investment tax credit, Congress provided that the subsidy was clearly and explicitly designed to be an investment stimulus to private business. Depreciation, on the other hand, is merely a method of recovering capital costs and may be taken by any taxpayer with respect to property held for the production of income or in a business or trade. By imposing the use of an extended rather than an accelerated cost recovery system when the affected property is leased back by a governmental entity, the potential benefits of investment for public infrastructure and other public capital projects are reduced when compared to those for private investment. In effect, the state-local sector is put at a competitive disadvantage in raising capital because the after-tax cost of capital investments by private corporations will be skewed to investments in nongovernmental areas.

The current era of austerity forces governments to approach the mid-1980s with a surplus in tough fiscal choices and a deficit in available resources. The need for fiscal survival compels governments to search for new ways to get by. The lease is a veritable chameleon of financial vehicles—putting on new costumes to suit the changing needs of public finance.

Resulting from conversations with practitioners, several broad issues have emerged which we wish to highlight:

It has been suggested that the Congress is overracting to a problem at the federal level by restricting a practice at the state and local level it perceives to be out-of-hand. No data are available on the volume of such financings.

We have been asked whether the assignment of an effective date prior to the date of enactment is an appropriate way for the Congress to legislate. We believe that affected parties should be given an opportunity to comment on proposals prior to their implementation.

State and local officials are painfully aware of the massive infrastructure and economic development needs now so eloquently described in the growing volume of studies. They wonder where the money will come from to arrest deterioration and to develop needed new facilities in the face of federal grant cutbacks.

In many localities, sewerage and waste disposal functions are performed by private entities under contracts with the local jurisdictions which may now be prohibited.

We remind you that the tax benefits associated with sale-leasebacks are being considered in a vacuum. For tax years after the period of depreciation ends and/or the investment tax credit has been taken, the effects on federal revenues will be diminished as taxable income rises.

Technical questions that relate to definitions are also of concern. The phrases "short-term or casual leases" and prohibiting leases where investors are "protected from loss" could have adverse consequences, depending upon IRS or judicial interpretations of those concepts. Similar restrictions do not apply to private users, and they appear to be discriminatory here. The same issues arise respecting the focus on service contacts.

If Congress succeeds in passing this legislation, will the result be a successful operation, but a dead patient? Is it always wrong to finance public works with the assistance of private investment?

STATEMENT

Introduction

Mr. Chairman and Members of the Committee, my name is Catherine L. Spain. I am Director of the Municipal Finance Officers Association's (MFOA) Federal Liason Center. With me is John E. Peterson, Director of MFOA's research arm, the Government Finance Research Center. Dr. Peterson is here to answer questions you may have on the municipal bond market and other concerns you may have about state and local capital financing.[1] The Municipal Finance Officers Association represents 9,200 members who are state and local government finance officials, appointed or elected.

MFOA's reaction to leasing restrictions

Over the years, the Municipal Finance Officers Association has testified before Congress on a wide range of public finance issues. In some instances, our appearances have been to provide technical background presentations on specific areas of public finance. On other occasions, we have come to articulate policy positions approved by our members and to support or oppose specific pieces of legislation. We have spoken out as experts in public finance and advocates for State and local governments' chief financial officers.

The subject of today's hearings—proposed restrictions on leasing by the federal government and other tax-exempt entities—has captured our attention because it restricts a new financing arrangement which is serving as an alternative to loans in the use or acquisition of capital assets by state and local governments. We are concerned that the proposal may restrict transactions which have real economic substance apart from tax considerations, and may limit experimentation in financing techniques and the provision of services at a time when experimentation is essential to find ways of reducing costs.

From the outset let me make it clear that the Municipal Finance Officers Association has not yet developed a policy statement with regard to this form of financing. Little more than two weeks have elapsed since the introduction of H.R. 3110. Therefore, as an organization we have not been able to ascertain if there is a consensus among our members on the appropriateness of the financing technique that you seek to eradicate. In less than 72 hours, our members will assemble at MFOA's Annual Conference where they will have their first opportunity to discuss the bill. This will be the first time any state and local officials will be gathered formally to discuss the proposals contained in H.R. 3110.

In the meantime, I feel compelled to react to the legislation. We do so not because the Association is for or against the bill, but because as practitioners and experts in public finance, we have a responsibility to explain why state and local governments are using this "creative" technique, and what forms of leasing are being used by nonfederal governmental entities. In addition, we have developed a body of knowledge on the subject of governmental leasing by state and local governments through the research activities of our Government Finance Research Center. Recently, MFOA published two volumes which organize and present the technical subject of leasing in a compact and objective way: Creative Capital Financing for State and Local Governments and A Guide to Municipal Leasing. To date, the data and information that have been compiled by the Subcommittee on Oversight in support of H.R. 3110 deal primarily with federal agency leasing. Our intent is to supplement the record (mostly anecdotal) on leasing by states and localities.

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[1] Ms. Spain and Dr. Peterson can be reached at MFOA's Washington Office at 1750 K St., N.W., Suite 200, Washington, D.C. 20006. (202) 466-2014.

Sale-leaseback financing has grown in use by state and local governments as a result of sharply curtailed federal grant programs, changes in the tax code, and unfavorable conditions in the bond market. An explanation of these trends and changes is found in Attachment I to this testimony. The technique allows for the reduction of the costs of public facility financing through the involvement of private investors. In the literature, this appeal has been likened to that for industrial development bonds; but, there is an important distinction to make: through industrial development bond financings, state and local governments assist private, taxable businesses by creating the convenient fiction that tax-exempt industrial development bonds have a fully public character. The same governments, through lease finance arrangements, mobilize federal tax subsidies for a purely public project by depicting the project as a private, taxpaying entity.[2]

The MFOA has carefully studied the market for tax-exempt bonds and through this research, it has expressed legitimate concerns about the market's capacity to absorb, without cost, so-called small-issue, conduit bonds. These are industrial development bonds for which the issuing local government has no finanical involvement with its own resources and also has no functional involvement in that the facility financed is one which it would not itself operate as its own public facility.

The Municipal Finance Officers Association has testified before Congress on a number of occasions in opposition to the use of tax-exempt bonds that only benefit private industries and are not functions of state and local government.[3] Our Association has two principal concerns about the present use of small-issue industrial development bonds. First, small-issue industrial development bonds are taking an increasing share of the tax-exempt bond market. The 1982 level of such long-term financings is estimated at approximately $13.8 billion, over 16.1 percent of the total market. Second, the availability of small-issue industrial development bonds in practically every state and community does not give any area an advantage in financing economic development through the use of industrial development bonds and may, in fact, promote further imbalance by financing the flight of downtown businesses from urban areas. As you may know, we are one of a few organizations that has supported legislation to restrict industrial development bonds.

Of major concern to state and local governments is the extent to which small-issue and other industrial development bonds are crowding out the market for conventional state and local debt issues, absorbing capital that would normally go to the financing of traditional governmental activity and driving up the costs of borrowing for all tax-exempt issuers.

In adopting our policy against industrial development bonds we carved out exceptions when the use of small-issue industrial development bonds might be acceptable. We believe these bonds can be used as an effective economic development tool if they are restricted to areas of serious economic deprivation. Further, the Association is to opposed to industrial development bonds if the public issuer remains associated both functionally and financially with the capital asset. We believe this may be the case in many of the sale-leaseback arrangements.

Our existing policy leads us to question whether industrial development bond financing should be prohibited in those situations where the investment tax credit is taken by the lessor as provided by H.R. 3110. Our policy writers never envisioned the coupling of industrial development bond financing with municipal leasing and the applicability of investment tax credits, so our criticism is reserved at this time.

Although we have no specific policy covering the provision which would mandate straight-line depreciation for properties used by state and local governments and deny the more rapid writeoff of depreciation, we do have a number of concerns. In designing the investment tax credit, Congress provided that the subsidy was clearly and explicitly designed to be an investment stimulus to private business. Section 38 of the Tax Code excludes from investment tax credit eligibility property used by government, but ERTA qualified this by excepting expenditures for the rehabilitation of public structures. Depreciation, on the other hand, is merely a method of recovering capital costs and may be taken by any taxpayer with respect to property held for the production of income of in a business or trade. By imposing the use of an extended rather than an accelerated cost recovery system when the affected property is leased back by a governmental entity, the potential benefits of investment for public infrastructure and other public capital projects are reduced when compared to those for private investment. In effect, the state-local sector is put at a competitive disadvantage in raising capital because the after-tax cost of capital investments by private corporations will be skewed to investments in nongovernmental areas.

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[2] See Roger J. Vaughan, "Rebuilding America: Financing Public Works in the 1980's Volume 2." (Washington, D.C.: Council of State Planning Agencies, 1983) p. 143.

[3] Before the Subcommittee on Oversight, Committee on Ways and Means, Apr. 8, 1981, and the Senate Finance Committee, Mar. 17, 1982.

There are many in the public finance profession that recognize the sale-leaseback for what it is—a fiscal device for expanding the tax-related enhancements that governments can call upon to entice investors. However, in order to stretch scarce dollars as far as possible, state and local governments have logically designed vehicles to employ every financial tool available. If Congress wishes to change the rules to create greater restrictions with respect to this form of financing for states and localities, it should do so in a neutral way, by also taking away the incentives to private investment that foster inequities in the allocation of capital. Not to do so will further impair the ability of governments to compete for capital.

The current era of austerity forces governments to approach the mid-1980's with a surplus in tough fiscal choices and a deficit in available resources. The need for fiscal survival compels governments to searching constantly for ways to just get by. The foregoing review has focused primarily on the technical issues involved in leasing by State and local governments and left many of the policy questions untouched. The practitioners we have consulted thus far concerning this legislation have mixed reactions to the leasing technique as often happens when new, imaginative attempts at solving problems are introduced. The lease is a veritable chameleon of financial vehicles—putting on new costumes to suit the changing needs of public finance.

As a result of our conversations with practitioners, several broad issues have emerged which we wish to note, despite the absence of policy direction from our members. Among others:

It has been suggested that the Congress is overreacting to a problem at the Federal level by restricting a practice at the State and local level it perceives to be out-of-hand. As noted in the Congressional Budget Office study, Trends in Municipal Leasing, the volume of leasing is unknown. If tax-motivated leasing by Federal agencies is the problem Congress is trying to correct, we think it is extremely unfair and restrictive to disadvantage State and local governments with respect to innovation.

We have been asked whether the assignment of an effective date prior to the date of enactment is an appropriate way for the Congress to legislate. We believe that affected parties should be given an opportunity to comment on proposals prior to their implementation. Further, many question the fairness of stopping in their tracks negotiations for such lease-financing arrangements that fall short of a binding contract because of the expenses that have been incurred by participants in negotiations.

Several finance officers observed that this form of financing involves the "privatization" of public services, a practice that has been encouraged by the administration and by individual Federal agencies. Sale-leaseback arrangements have provided a very direct method of obtaining participation from the private sector in joint ventures.

In many localities, sewerage and waste disposal functions are performed by private entities under contracts with the local jurisdictions. These are "regulated" by law and contract. These and other services often may be provided by the private entity less expensively than by the governments. Innovative private enterprise and governments are developing constantly new areas for private provisions of services. Indeed, there appears to be a Federal government policy of encouraging "privatization."

State and local officials are painfully aware of the massive infrastructure and economic development needs now so eloquently described in the growing volume of studies. They wonder where the money will come from to arrest deterioration and to develop needed new facilities in the face of Federal grant cutbacks.

We would like to ask why Congress is involving itself in these questions when courts, revenue rulings, and other legal authorities have already distinguished between the phony and the real with respect to leases and service contracts. That some taxpayers are attempting to circumvent the rules, either regarding State-local or private facilities, does not mean that they will succeed or that there is any need for legislation directed at State and local governments.

We remind you that the tax benefits associated with sale-leasebacks are being considered in a vacuum. For tax years after the period of depreciation ends and/or the investment tax credit has been taken, the effects on Federal revenues will be diminished as the taxable income of the private investors rises.

Technical questions that relate to definitions are also of concern. The phrases "short-term or casual leases" and prohibiting leases where investors are "protected from loss" could have adverse consequences, depending upon IRS or judicial interpretations of those concepts. Similar restrictions do not apply to private users, and they appear to be discriminatory here. The same issues arise respecting the focus on service contracts.

And finally, if Congress succeeds in passing this legislation, will the result be a successful operation, but a dead patient? Is it always wrong to finance public works with the assistance of private investment?

Types of and reasons for leasing

Leasing, when it involves state and local governments, can be complex and confusing. There exist different reasons for choosing one form of leasing over another. Ranging from federal tax and securities considerations to state controls to the type of asset being sought, these reasons can provide state and local officials a menu of lease financing options. For the most part, the reasons why state and local governments use leasing and service contracts do not differ materially from the reasons other entities do so. In order to help you sort out among the definitions of types of leases and explain some of the reasons that state and local officials choose lease financing, we are providing the following brief discussion.

True or operating lease.—In an operating lease, the governmental or private lessee acquires the use of an asset that is owned by a private investor throughout the term of the lease. The lease term is shorter than the asset's useful life. Under federal tax laws and regulations, the lessor can claim tax benefits of depreciation. The investment tax credit, generally not available when an asset is used by the public sector, a discriminatory factor of some concern, is available, however, in the case of an old or historic building that has been substantially rehabilitated. Offsetting the tax benefits of the true lease, the lessor must pay income taxes on the full amount of the lease or rental payments.

Sale-leasebacks and leveraged leases are forms of true leases. In many respects, safe harbor leasing for mass transit vehicles also has the characteristics of an operating or true lease but, in general, ownership, except for tax purposes, remains with the government.

A leveraged lease is a true lease that involves a lessee, a lessor, and a lender to the lessor. The lender loans the lessor substantial financing—50 to 80 percent of the capital needed to buy the leased property. In return, the lender has recourse to the leased property and the lease payments but not to the general credit of the lessor. The lessor, although providing only a portion of the capital needed to buy the leased property, may depreciate the full purchase price of the property. Leveraged leases are often used for very expensive capital projects in which there are multiple lessors and lenders and for which the legal documents are very complex.

In a sale-leaseback, the owner of property sells the property to an investor and simultaneously executes an agreement to lease the property back from the buyer. Structured as a true lease, a sale-leaseback enables the seller-lessee to transfer the tax benefits of ownership (depreciation) to the buyer-lessor in exchange for favorable or low lease payments.

As a result of the Economic Recovery Tax Act of 1981, sale-leasebacks, whether involving state and local governments or private parties, have become more attractive because of the Accelerated Cost Recovery System (ACRS) of depreciation and, in the case of old or historic structures in need of substantial rehabilitation, the extension of the investment tax credit (ITC) when those structures are used by the public sector. Such use of the ITC obligates investors to depreciate the building along the straight-line method.

A case study of a hypothetical sale-leaseback arrangement of an older structure that shows the cost effectiveness for the city as well as the cash flow for the investor is provided as Attachment II. This case study was published in our recent book, Creative Capital Financing.

Conditional-sales lease or lease-purchase agreement.—A contract that is called a lease but is in substance a purchase or sale for which payments are made in installments over time is called a conditional-sales lease or a lease-purchase agreement. The lessee acquires ownership as well as use of the leased property from the inception of the lease term, and the lease typically specifies a date on which title to the property changes hands. The periodic payments established in the agreement are divided into principal and interest portions, and, if the lessee is a state or local government and the lease is structured properly, the interest portions are exempt from federal and, in some states, state income taxes. Such a lease is also called a tax-exempt or municipal lease, and because of the federal tax exemption, lessors are able to charge lower interest rates on such leases than on other conditional-sales leases or on true leases of comparable risk and term.

Tax-exempt leases or lease-purchase agreements usually have a non-appropriation clause to avoid having the agreements classified as long-term debt under state or local laws. This clause allows a government lessee to terminate, without penalty except for loss of the leased property, a lease for which funds are not appropriated beyond the current fiscal year or period. Lessors frequently protect themselves from non-appropipration by charging a higher interest rate than that charged for a guaranteed contract term and by including in the contract a non-substitution clause that states that the lessee cannot lease or purchase replacement equipment within a specified time.

Service contracts.—As previously stated, property that is used by governments under leasing arrangements generally does not qualify for the investment tax credit. However, a recent court case involving the Xerox Corporation and the federal government allowed the ITC to be taken since Xerox was providing a service with duplicating machines rather than actually providing the equipment. (*See Xerox Corporation* v. *United States*, 1980–82 U.S. Tax Court 9530 (U.S. Court of Claims, 1980)). While this is a complicated concept and one that is difficult to apply broadly, certain types of equipment or facilities may qualify logically for this treatment and allow for the pass-through of the ITC. Such assets may include resource recovery facilities, hospital equipment, port facilities such as cranes, utilities, and fire companies.

Why have state and local governments turned increasingly to leasing agreements to acquire the capital assets they need to provide public services? Although the overriding reason may be to spread the costs of capital acquisitions over several fiscal periods or years or to reduce costs, the need to do this can arise from different underlying conditions. The reasons for and conditions that underlie government use of lease financing are examined below.

The reasons for true leasing include:

Rapidly changing technology.—Rapidly changing technology in the development of equipment and other capital assets is one reason why governments and private organizations enter into operating types of true leases for some assets. For example, many local governments and private users lease rather than purchase or lease-purchase computer and data processing equipment because they do not want to be saddled with outdated equipment as more advanced models become available. The term of the lease may extend for a specific period, but often it will be changed mutually as new products come on the market.

Short-term need.—Probably the most widespread reason for an operating or true lease is that the lessee needs certain equipment or property for only a short time. For example, governments sometimes establish pilot programs and lease the equipment that they need to operate the program. They may also use true leases to test equipment for a period before making a commitment to purchase or lease-purchase the equipment.

Service and maintenance advantages of a true lease.—Governments and private users can often obtain better service and maintenance on equipment or property leased under an operating true lease than under a lease-purchase agreement. Under a true lease, the lessor owns the property during and upon expiration of the lease term. Moreover, the lease term is usually relatively short, often only a year. Even if the lease has a multi-year term, the lessee frequently has the right to cancel the contract at the end of any year. Under these conditions, the lessor has a strong incentive to service and maintain the equipment or property so that it remains in good condition. The lessor's investment in the property and any return on that investment may depend on the property being in good enough shape to be released or sold at an adequate price at the end of the lease term or during any year thereof. Moreover, many contracts for true leases give the lessee the right to hold back or set-off periodic payments to the lessor if the leased equipment does not function as it should. This also serves as an incentive for the lessor to service and maintain the property.

Economic development.—State and local governments can enter into true leases through sale-leaseback arrangements for purposes of economic development, whether or not historic rehabilitation is involved. Such arrangements can provide incentives for private investment in publicly used buildings as well as encourage complementary private development within an urban renewal or economic development district.

Cost effectiveness.—Frequently, leasing arrangements offer less expensive opportunities for governments to finance capital assets. This cost effectiveness, measured in relation to selling bonds or outright purchase and taking into account the present value of future dollars, can release funds for other needs.

New Federal income tax advantages of true leases.—The Economic Recovery Tax Act of 1981 (ERTA), as amended by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), has made sale-leaseback types of true leases by governments and private users more attractive now than before. ERTA established the Accelerated Cost Recovery System (ACRS) for depreciating capital assets. This new depreciation system increases the after-tax cash flow to the owners of qualifying capital assets, which serves as an incentive for private firms and individuals to do more leasing of capital assets to governments and private users under true leasing arrangements. Second, ERTA permits lessors to take a credit against federal income taxes for rehabilitating historic or older buildings that they lease to governments and private users under long-term, true leasing arrangements. Third, ERTA created the "safe harbor" true lease, which, pursuant to TEFRA amendments, state and local governments can use through 1987 to lease mass commuting vehicles.

In addition, many governments and private users may want to or have to choose between true leasing and tax-exempt lease-purchasing to finance their capital needs and acquisitions. Since H.R. 3110 only addresses true leases, at this point we will just enumerate the reasons for entering into a lease-purchase arrangement:

Lack of revenue for recurring capital replacements;

Backlog of capital replacement needs;

Need to spread over several years the cost of expensive equipment for which bond financing is impractical;

Occurrence of a one-time or non-recurring event that necessitates major capital expenditures;

Need to conserve operating reserves;

Policy to limit capital reserves to major improvement projects;

Policy to preserve reserves for investment purposes; and

Cost-effective alternative to bond financing.

Mr. Chairman, thank you for this opportunity to testify on H.R. 3110. We stand ready to assist the Committee on any matters in which we may be of help.

ATTACHMENT I

Chapter 3 *
RECENT TRENDS IN THE TAX-EXEMPT SECURITIES MARKET

The need for innovations in capital financing should be examined in the context of the traditional sources and uses of capital funds and how these have been affected by changes in the economy, budget priorities, and the general environment of fiscal restraint. The recent stresses in the tax-exempt securities market, their causes and manifestations, are reviewed in this chapter, since most of the vehicles to be discussed later are found in the securities market or represent close substitutes for market instruments.

Capital Spending and Financing

The problems of the unmet capital needs and deteriorating condition of public stock have received widespread attention.[1] The causes are complicated, but may be distilled to the following: because of changed political priorities that have put emphasis on current spending, persistent fiscal restraint at all levels of government, and disruptive credit market conditions, states and localities have not been spending enough on the repair and replacement of public facilities. State and local capital spending, which grew during the decades of the fifties and sixties, declined in real terms throughout the seventies and has been particularly depressed in the early 1980s.

Since 1968, state and local government capital investment in constant 1972 dollars has fallen by one-third, from a high of $35.9 billion to $23.6 billion in 1981.[2] Measured in per capita constant dollars, state and local public works investment declined from $179 per person in 1968 to $103 per person 13 years later. Capital expenditures make up a diminishing share of total outlays of state and local governments: in 1960, state and local governments spent 27.1 percent of their budgets on infrastructure; by 1980, they were spending only 15.4 percent on capital items. Judging by the most recent construction data, state and local spending has sunk even further over the first two years of the 1980s, with spending levels in current-dollar terms running more than 10 percent lower in 1982 than in 1980.[3]

Examining the means of financing of capital facilities provides insights into the current difficulties. The last 20 years have marked a trend away

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* Excerpted from John E. Petersen and Wesley C. Hough, Creative Capital Financing for State and Local Governments (Washington, D.C.: Government Finance Research Center, MFOA, 1983) pp. 11-20.

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from the use of own-sources by states and localities and, in particular, that of debt financing, and towards great reliance on the federal government. As budget priorities shifted to meet current service and transfer payment program needs, grants to states and localities for capital purposes—while nominally growing—failed to keep pace with the explosive growth in grants for non-capital purposes. Moreover, capital grants were typically episodic and "single-shot" efforts, providing for initial investments in major new projects and not oriented toward providing a financial or institutional base for the subsequent problems of operating and preserving the capital infrastructure once in place.

Table 3.1 provides a broad perspective on the sources of funds used to finance state and local capital outlays and reflects a general ebbing in the importance of long-term debt and its replacement by federal grants. By the last half of the 1970s, states and localities depended on federal grants to finance an estimated 35 to 40 percent of their capital spending, therefore rendering this component of their spending highly vulnerable to changes in federal grants policy.[4]

The recurring budgetary cutbacks at the federal level are now withdrawing a major source of capital funds. While this process takes time to materialize in terms of reduced aid flows and spending, it seems clear that state and local governments will be increasingly forced to rely more heavily on their own sources of financing. Such a reliance on own sources boils down to greater use of current revenues or more debt financing. On the current revenues side of the equation, prolonged fiscal pressures were brought on by a wave of home-grown tax and expenditure limitations that tainted and made difficult increasing any resource allocations to government. Moreover, several years of sluggish economic growth further depressed current revenues and rendered them of very limited help in meeting capital needs. In fact, the

TABLE 3.1
State and Local Capital Outlay Financing
Percentage Composition of Sources of Funds

	1952–57	1960	1970	1977	1980
Long-Term Debt:	56.0%	37.1%	51.0%	43.3%	37.0%
Federal Aid:	8.5	20.0	22.0	32.1	36.0
Other Sources:	35.5	42.9	27.0	24.6	27.0
TOTAL	100.0	100.0	100.0	100.0	100.0

Sources: 1952–57—Alan Manvel, "State and Local Government Financing of Capital Outlays," in *State and Local Public Facility News and Aiming*, Joint Economic Committee (December 1966). Data for the subsequent years: George Peterson, "Capital Spending and Capital Obsolescence" in Roy Bahl's *The Fiscal Outlook for Cities*, Syracuse University Press, 1978, and authors' estimates for 1980.

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demands on current budgets to keep governmental operations going in the face of insufficient and erratic revenues have further restricted capital spending by reallocating to current uses funds that otherwise might have gone to capital purposes.[5]

This leaves the remaining alternative: state and local government must rely increasingly upon borrowing to finance their capital needs. Unfortunately, many of the same economic circumstances that have led to the deteriorating support for capital spending from federal grants and out of current revenues are reflected in very unstable credit market conditions, making borrowing a volatile and expensive means of raising funds for capital projects. It is the adverse conditions in the financial market—against the background of unmet capital needs, both public and private, and scarce resources on the current accounts—that form the primary basis for the surge of creative activity in the realm of state and local capital finance.

But it is not only the dire want of conventional capital-financing avenues that has led the tax-exempt market to devise new vehicles. In a more positive vein, the market has been changing by opening up new sources of capital—investors that are ready and willing to part with their savings if their particular needs can be met. Thus, in the teeth of record high interest rates and intense uncertainty about the future (and because of it, too), tax-exempt issuers were able to tap the short-term market and were able to benefit by burgeoning demand for tax-exempt short-term paper.

Correspondingly, not all state and local governments can be considered victims of high interest rates. For some, the high rates of interest were a source of substantial revenues. Those with sufficiently flexible cash management policies and investible assets made out very well indeed by investing their money in short-term taxable market instruments at record rates of return.[6] Furthermore, the availability of high reinvestment rates no doubt actually encouraged borrowing by certain issuers who were able to take advantage of the sizable opportunities for arbitrage—borrowing at high tax-exempt rates and reinvesting the proceeds at taxable rates that were even higher.[7]

Changes in the Municipal Bond Market

A combination of cyclical and secular factors have brought rapid and radical changes to the tax-exempt market over the past few years. State and local governments have shared the difficulties of high interest rates and recessionary conditions that now burden all sectors of our economy. But governments have come in for some special problems over the past year. These difficulties arose in large part from simultaneous changes in the federal tax code, reductions in the federal budget, and the impacts of recession on revenues. To these changes, which reduced investor demand for tax-exempts while making access to that market even more important, must be added the pressures brought by restrictive monetary policy and a continuing growth in private-purpose tax-exempt borrowing. The latter swelled the supply of the tax-exempt securities in the midst of weak demand for such securities, particularly in the long maturities.[8]

The pressures in the tax-exempt market can probably best be measured by comparing its cost of capital to that in the taxable market. Over the past two years, the value of tax exemption as a means of reducing interest rates has been severely eroded. As a consequence, the borrowing costs for state and local governments have risen faster than the general rise in interest rates.[9] As Table 3.2 shows, tax-exempt rates shifted from a historic range of 65 to 70 percent of comparable taxable bond yields up to 80 to 85 percent in the long end of the market in late 1981 and early 1982. (The second half of 1982 brought a substantial downdraft in rates but the ratio of rates remained close to 80 percent.)

Changes enacted in the Economic Recovery Tax Act of 1981 (ERTA) contributed to systematically higher interest rates for municipal bonds.[10]

TABLE 3.2
Levels and Ratios of Interest Rates: *Bond Buyer* 20 Bond Index (Tax-Exempt),
Moody's All-Industry Corporate Bonds (Taxable)
1978 to 1982/IV

Year/Quarter	Bond Buyer 20 Bond Index (Tax-Exempt)	Moody's All Industry Corporate Bonds (Taxable)	Ratio of Tax-Exempt To Taxable (%)
1978 (yr.)	6.07%	9.07%	66.0%
1979 (yr.)	6.53	10.12	64.5
1980/I	8.56	12.80	66.9
1980/II	7.86	12.32	63.8
1980/III	8.79	12.30	71.5
1980/IV	9.61	13.67	70.3
1981/I	9.97	14.09	70.8
1981/II	10.68	14.89	71.7
1981/III	12.03	15.65	76.9
1981/IV	12.59	15.64	80.5
1982/I	12.96	15.95	81.3
1982/II	12.19	15.55	78.4
1982/III	11.06	15.03	73.6
1982/IV	10.14	13.49	75.2

Source: *Resources in Review*, Government Finance Research Center, Municipal Finance Officers Association.

Several provisions of ERTA relating to individual taxpayers had adverse consequences for tax-exempt interest rates relative to those on taxable securities. Among these were the following:

- Reduction of personal income tax marginal rates, especially the lowering of the top-bracket rate from 70 percent (on unearned income) to 50 percent for all income. The rate reductions are scheduled to continue at a rate of 10 percent a year, with indexation commencing in 1985. Thus, starting in late 1981, the long-term prospects were for progressively lower rates into the future.
- Reduction in the capital gains rate, which dropped from a maximum of 28 percent to 20 percent. Over the long haul, this change should accent the attractiveness of holding equities in comparison to fixed-income securities, such as municipal securities, a particularly important trade-off in the case of wealthy investors.
- Expansion of various competing income-sheltering opportunities in individual retirement savings plans (IRA and Keogh), the partial exemption of interest income, the Utility Dividend Reinvestment Program, and the creation of the All Savers Certificate. The latter wrinkle represented a widely available tax-exempt, short-term instrument that was federally guaranteed.

On the corporate tax side of the ledger, the following provisions in the ERTA tax law appeared to have adverse impacts on tax-exempt issuers:

- Rapid expansion under ERTA of leasing tax shelters (the Safe Harbor provisions). This change permitted firms to sell tax benefits to the highest bidder, thus creating billions of dollars of tax-shelter investment opportunities to compete with tax-exempt securities.
- Increase in the Investment Tax Credit (ITC) and Accelerated Cost Recovery Schedules (ACRS). These steps generally enhanced the after-tax economic rate of return on private investments, thus lessening the need for tax shelter provided by municipal securities because less income would be subject to taxation.

Reducing the need for shelters and expansion of income sheltering opportunities available to individuals and corporations proved to be especially ill-timed. In further reducing investor demand for municipal securities, the 1981 tax laws compounded several longer-term problems caused by generally poor economic conditions—recession and high interest rates—and changing investment objectives. Demand for tax-exempt bonds by the two major institutional investors, namely commercial banks and property and casualty insurance companies, practically evaporated after 1979 due to poor profitability and the availability of competing tax shelters. Since the early 1970s, commercial banks have been shifting portfolios away from tax-exempt bonds. Through much of the decade this shift was offset as property and casualty insurance companies increased demands and kept the long-term tax-exempt market buoyant. Banks and insurance companies together in the late 1970s acquired 80 to 90 percent of net increases in municipal bonds. However, these institutions have shown only minimal interest in tax-exempts since 1980. In both cases, the immediate culprit was the reduced profitability of doing business. Property and casualty underwriting losses have grown to high levels, with only slow recovery in prospect.

The reaction of the tax-exempt market to the withdrawal of the institutional investors has been traditional, i.e., a heavy reliance on individual investors to absorb the supply of new tax-exempt securities. The percentage of outstanding tax-exempt debt held by individuals and mutual funds shot up in 1981 and 1982. According to flow-of-funds figures through the third quarter of 1982, the household sector and mutual funds absorbed about 80 percent of the new supply of tax-exempt debt that year.[11]

The meteoric growth in investments by tax-exempt funds has helped to mobilize individual investment. Particularly important has been the growth in the tax-exempt money market funds, which has created a strong demand for short-term tax-exempt paper.[12] During 1981, tax-exempt money market holdings grew by $3 billion, which represented approximately three-fourths of the increase in outstanding tax-exempt short-term debt reported for that year. By the end of 1982, there were $13.2 billion in aggregate holdings.[13]

Issuers facing high long-term interest costs have willingly shifted their borrowings to the short-term market, often devising new instruments tailored to match the needs of the funds for highly liquid tax-exempt securities. The growing importance of short-term borrowing—both proportionately and in dollar terms—is depicted in Table 3.3. The sales figures in that table do not tell the whole story of shortened maturities: many nominally long-term bonds sold have taken on the characteristics of short-term obligations. As a result,

TABLE 3.3
State and Local Government Debt Sales
1978–1982
(in billions of dollars)

Year	Long-Term	Short-Term	Total	Short-Term as Percentage of Total
1978	$46.2	$21.6	$ 67.9	31.8%
1979	42.3	20.9	63.2	33.1
1980	47.1	26.5	73.6	36.0
1981	46.1	34.4	80.6	42.7
1982$_p$	73.6	44.8	119.0	37.6

$_p$—preliminary data
Source: *The Bond Buyer*

the degree of the shortening of the liability structure of governments is probably greatly understated by the trends shown in Table 3.3.

Any examination of the changes in the municipal bond market would be incomplete without reference to the heavy demands placed on the market by nontraditional uses of funds. Over the past decade, a myriad of tax-exempt borrowing devices has been created, designed to raise money at tax-exempt rates which, in turn, is re-lent to the private sector for such things as industrial and commercial development, power facilities, student loans, hospitals, and mortgages on private dwellings. Such borrowing, generally considered to be forms of industrial revenue bond financing, lately has represented (depending on the definitions employed) somewhere between 25 and 50 percent of all long-term tax-exempt financing.[14]

As a group, such non-traditional borrowers are powerful competitors with traditional governments for investment dollars. In fact, in the realm of creative capital financing, such nontraditional financing purposes are typically much more able and flexible enough to assume the risks entailed in the new financing approaches than are traditional governmental-purpose borrowers, especially the smaller, less sophisticated entities.[15]

Impacts of the Tax Act of 1982

Starting in late summer of 1982, the bond markets enjoyed a rally as interest rates began to decline under the twin influences of an increasingly depressed economy and a relaxation of monetary policy on the part of the Federal Reserve Board. Despite a flood of new issues, the tax-exempt bonds followed the general trend, with especially good recovery in the short-term area. However, the longer term prospects for the market continued to be, at best, complicated. Complicating factors are the implications of once-again altered tax treatments and the continuing weakness on the part of institutional demand and, hence, continued heavy reliance on the household-oriented "retail" market.

The 1982 Federal Tax Act (TEFRA) further changed the status of municipal securities (and that of alternative investments) in a variety of ways.[16] Two of the changes in the tax code most likely will spell higher costs for municipals over the intermediate to longer haul: the partial removal of the deductibility of bank interest costs used to finance tax-exempt securities and the requirement that all municipal bonds issued after July 1, 1983, be in registered form.[17]

In several other areas affected by TEFRA—the changes in the restrictions on the use of industrial revenue and municipal mortgage bonds, the new taxation rules for life insurance companies, curbing of the leasing provisions, and the tightening-up of the use of certain competing tax shelters and their subjugation to a revised minimum income tax (that excludes tax-exempt interest income)—the ultimate impacts constitute a mixed, but most likely negative, picture. Overall, there appears to be little reason to believe that the tax-exempt market's position relative to the other markets has improved or that its more volatile, credit-sensitive behavior will be materially altered.

Perhaps one of the more critical developments over the past few years is the extent to which the entire municipal securities market has become ultra-sensitive to changes—real or potential—in the federal tax code. For example, the pendency of the bond registration requirement and the year-end effective date for the new interest deduction requirements for banks greatly accelerated tax-exempt issues at the end of the year. And at this writing, the same rush to the market is occurring in the case of the latest creative financing twist, the insured savings-backed bond: $750 million have been sold since October of 1982. Congress and the Administration are already taking aim at its extinction.[18]

No discussion of alterations to the municipal bond market and its ability to raise capital for state and local governmental needs would be complete without a discussion of the credit concerns that continue to pervade the market. The financial condition of the state and local sector has deteriorated over the past few years; and, yet, there remains a huge backlog of unfunded capital spending needs. The rating agencies are certainly aware of the financial problems and have been lowering ratings to reflect the more perilous prospects for governmental issuers. Moody's Investors Service, Inc. reduced the credit rating of nearly twice as many tax-exempt bond issuers as had their rating raised during the first eight months of 1982. The 384 downgradings during this period were more than four times as many as were reported for all of 1979.[19] Furthermore, near-term prospects for ratings appear to be no better, and a default or two by major issuer(s) could intensify a flight to quality by investors.[20] With the ongoing concerns as to creditworthiness and the reliance on retail sales to individuals, marketing considerations have been instrumental in requiring insurance and guarantees to back up weaker or unusual credits. No place are these tendencies more evident than in many of the creative devices reviewed in the following chapters.

In the following chapters, several varieties of creative financing instruments and arrangements are reviewed, and outlines of their operation and their advantages and disadvantages are presented. The first set of items examined will deal with a common element in many of the creative financing devices, the incorporation of third-party credit enhancements (e.g., insurance, letters of credit, and guarantees) into transactions. Next, there is a discussion of major new developments in the short-term, tax-exempt market, focusing on commercial paper and demand notes. This is followed by an explanation of variable rates, put options, warrants, and original issue discount securities, which have become important forms in the intermediate- and longer-term markets. There is then a review of recent developments in governmental lease arrangements, with emphasis on the newly evolving tax-exempt lease concepts.

We conclude the overview with two chapters of overarching concerns. First, there is an examination of various marketing considerations: how creative devices have performed in the markets, how they are packaged and sold to investors, and the kinds of assistance required in the marketing process. This is followed by a discussion of the policy issues involved in the use—and possible abuse—of creative financing.

Notes

[1] For popular treatments of the subject, see "The Crumbling of America," *Time* (April 27, 1981); "The Decay That Threatens Economic Growth," *Business Week* (October 18, 1981); "The Decaying of America," *Newsweek* (August 2, 1982); and "To Rebuild America—2,500,000,000 Jobs," *U.S. News and World Report* (September 27, 1982).

[2] Government Finance Research Center, *Financing Infrastructure for Economic Development*, (Washington, DC: Municipal Finance Officers Association, January 1983), draft paper, page I-11.

[3] See John E. Petersen, "Financial Roundup: In the Belly of Recession," *Resources in Review* (March 1983, forthcoming): 5.

[4] See John E. Petersen, "Financial Roundup: Public Capital Crisis?" *Resources in Review* (July 1982): 5.

[5] In fact, the occurrence of large operating deficits and cash flow shortages has switched current operating budgets from capital fund providers to demanders of credit, increasing the competition for funds in the market.

[6] See Philip Dearborn, "Financial Roundup: When Government Is Both A Lender and A Borrower," *Resources in Review* (November 1982).

[7] The reinvestment opportunities of tax-exempt proceeds are limited by Section 103(c) of the Internal Revenue Code, which provides generally that bonds issued by states or localities will be arbitrage bonds (and the interest on them not tax-exempt) if the proceeds are expected to yield "materially higher" than the yield on the bonds. Numerous exceptions are found, including that for construction projects, the reinvestment yield is unrestricted for a temporary period of up to three years. Also, other questions of arbitrage depend greatly on the expected use of proceeds, and the regulations permit issuers to execute certificates about the use of proceeds at the time of issuance. For an extensive discussion see Frederic Ballard, *ABCs of Arbitrage* (Packard Press, 1981 Revision).

[8] For recent reviews of the changes in the tax-exempt market and their causes and implications, see John E. Petersen, *Has the Municipal Bond Market Undergone Fundamental Change?* (Washington, DC: Government Finance Research Center, May 1982).

[9] For a recent discussion of the changing ratios of tax-exempt and taxable rates and their policy implications, see David Beek, "Rethinking Tax-Exempt Financing for State and Local Governments," *Quarterly Review*, Federal Reserve Bank of New York (Autumn 1982): 30–40.

[10] A discussion of the impact of ERTA's provision on the municipal bond market is found in the testimonies of Messrs. Petersen, Altman, and Trent in U.S. Congress, Joint Economic Committee, *Chaos in the Municipal Bond Market* (Washington, DC: Government Printing Office, 1981).

[11] Board of Governors, Federal Reserve System, *Flow of Funds Accounts Third Quarter 1982*.

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[12] See John Fitzgerald, "Localities Rush to Short-Term Market for Funds," *The Daily Bond Buyer* (May 1981): 1.

[13] Investment Company Institute. Because of debt reporting and classification difficulties, it is hard to say how much of total short-term debt this represents. However, the $10 billion increase in tax-exempt money market holdings during 1982 represented approximately 20 percent of the net increase in total state and local government debt outstanding for the year.

[14] See John E. Petersen, *The Municipal Bond Market: Recent Changes and Future Prospects*, (Washington, DC: Government Finance Research Center, January 1981).

[15] For an extended discussion of the new creative devices, see John E. Petersen, "Creative Capital Finance," *Public Budgeting and Finance in the State and Local Sector* (Winter 1982): 73–89.

[16] John Bates and Robert Doty, *The Impact of 1982 Federal Legislation on Tax-Exempt Financing* (New York: Sorg Printing Company, 1982).

[17] For a discussion of these changes and their impacts, see John E. Petersen, "Municipal Bonds in Registered Form: What It Means, How It Works," *Resources in Review* (November 1982); and "The Impact of the Proposed Corporate Minimum Tax on Tax-Exempt Bonds," *Governmental Finance* (June 1982).

[18] Joe Mysak, "California County Planning $300 Million FSLIC-Backed Housing Bond Issue," *The Bond Buyer* (February 16, 1982): 1.

[19] "Market & Investments: The Specter Haunting Municipal Bonds," *Business Week* (November 29, 1982): 89–90.

[20] "Financial Roundup: Credit Analysts Look to 1983," *Resources in Review* (January 1983): 5.

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Case Study of a Sale-Leaseback Transaction as an Alternative to Direct Debt Issuance

The hypothetical case study that follows demonstrates how a government can utilize a sale-leaseback agreement to renovate a publicly used building. In this instance, the agreement makes it possible to renovate the building at a lower cost than would have been possible had traditional general obligation bond financing been used. The study will introduce the basics of a financial analysis of a sale-leaseback, discuss several steps necessary to evaluate the transaction, and illustrate the potential savings as compared to the alternative of issuing bonds to finance the same project.

The sale-leaseback financing arrangement requires that the government sell a building it currently owns to a private investor and simultaneously enter into a "true" operating lease with the new owner to continue the public use of the building. Sale of the building is necessary because ownership must reside with the investors in order for them to benefit from federal tax incentives. To ensure that the governmental unit has maximum control of the building's disposition while it is in private hands, ownership of the land is retained by the city. Using a ground lease, the land will be leased to the purchasers of the building. Further control is achieved from the structure of the city's operating lease for use of the building. A "net lease" is used, making the city responsible for all operating expenses. At the end of the lease, the government intends to repurchase the building, and it will be given the first option to purchase. However, in order to qualify as a "true" lease, the contract cannot specify the future price at which the building can be repurchased.

Before comparing the financial costs and benefits of a sale-leaseback to those of straight debt financing, a governmental unit should take several steps. First, in consultation with its attorney, it should determine whether it has the authority to sell government property and to enter into an operating lease. If this authority exists, the governmental entity should identify an investor, or group of investors, that has taxable income it wishes to shelter. The investor also must be prepared to make an up-front payment for the tax benefits that will accrue over the length of the lease. For simplicity, in this example it is assumed that only one investor is involved, but in many sale-leasebacks a group or syndicate of investors is formed and the tax benefits are divided among them. (Regardless of the number of investors, the tax benefits to owners and the financing costs to the governmental unit are the same.)

Background Information

The following background information is necessary to an understanding of this case study. Engineers have estimated the cost of the necessary renovation work at $4 million. The building is 43 years old. Because the building is more than 40 years old, under ERTA the investor will be able to take a 20 percent investment tax credit on eligible renovation costs. Further eligibility requirements for the ITC are:

- the building must have been in service before renovation began;
- at least 75 percent of the existing external walls must be retained;
- the ITC may not be applied to costs incurred to expand the building; and
- the work must entail substantial rehabilitation.[4]

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[4] "Economic Recovery Tax Act of 1981," signed, August 13, 1981, *U.S. Code Congressional Administrative News*, 6, (August 1981).

Excerpted from John E. Petersen and Wesley C. Hough
Creative Capital Financing for State and Local Governments
pp. 84-91.

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The cost of the building to the investor is set at $5 million. In addition to the $4 million cost of the renovation, the building's current market value is estimated at $250,000. The final purchase price "step-up" (the difference between the purchase price of $5 million and cost of $4.25 million) is primarily to compensate the city for acting as contractor and overseeing the renovation of the building.

A breakdown of the components of the purchase price is presented in Table 10.1. The governmental unit's net cash benefit from the transaction is $1 million. This sum is derived by subtracting the cost of renovations from the total price to the investor and represents the current value of the building and the contracting fee.

Finance sources are depicted in section B of Table 10.1. To finance the $5 million sales price, it is assumed that the investor makes an equity contribution of 23 percent of the purchase price, or $1.15 million. For the remainder, the city's Industrial Development Authority approves the issuance of a $3.85 million industrial revenue bond (IRB). The interest rate on this 15-year IRB is assumed to be 12 percent. The IRB proceeds will be used by the investor to finance the debt portion of the transaction. The city's lease payments are the security behind the IRB, although the investor is liable for repayment of the debt.

A schematic representation of the legal and financial relationships involved in this transaction is given in Figure 10.1. The governmental unit has several options available for use of proceeds from the building's sale. It may choose to refund outstanding municipal bonds, to finance certain other capital improvements, to supplement the general operating fund, or to establish an escrow account, the interest earnings on which would be used to reduce the annual lease payments. For the purposes of this example, the governmental unit takes the last approach and establishes an escrow account with the sale proceeds. At the completion of the lease, the $1 million principal amount will be available to be used to repurchase the building.

TABLE 10.1
Financial Assumptions for Case Study

(A) Components of Price:	
Cost of renovations	$4,000,000
Current value of building	250,000
Step-up (government's contracting fee)	750,000
Total Price to Investors	$5,000,000
(B) Components of Financing:	
Equity contribution	$1,150,000
Industrial revenue bond	3,850,000
Total Financing	$5,000,000

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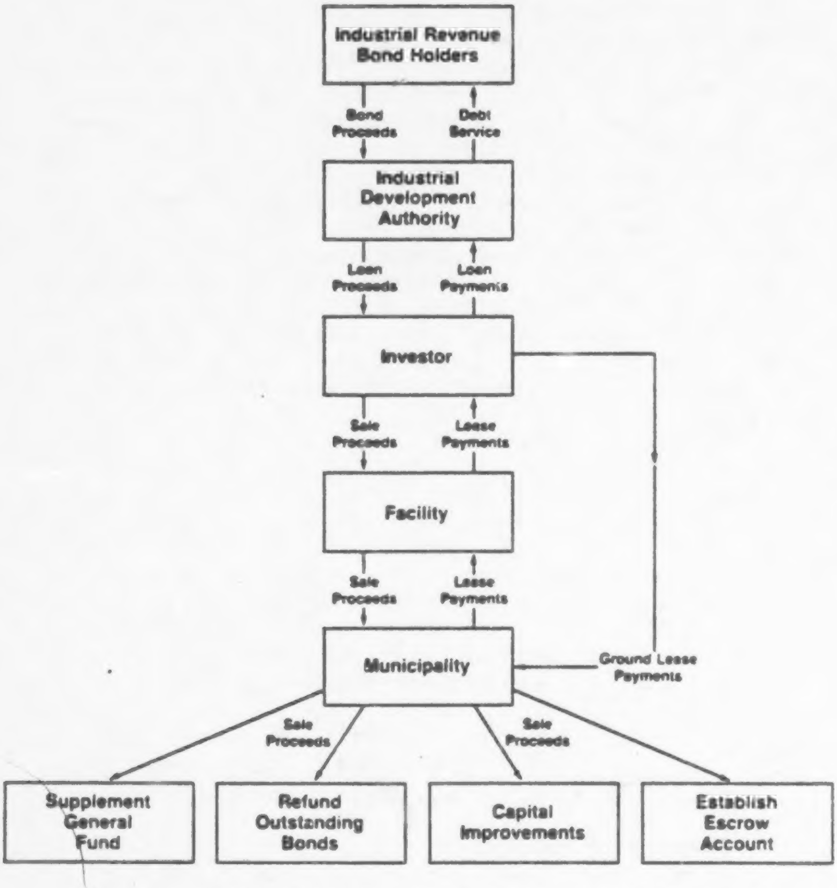
FIGURE 10.1
Sale-Leaseback of Government Property


Industrial Revenue Bond Holders
Bond Proceeds
Debt Service
Industrial Development Authority
Loan Proceeds
Loan Payments
Investor
Sale Proceeds
Lease Payments
Facility
Sale Proceeds
Lease Payments
Municipality
Ground Lease Payments
Sale Proceeds
Sale Proceeds
Supplement General Fund
Refund Outstanding Bonds
Capital Improvements
Establish Escrow Account

Adapted from: Goldman Sachs & Co., "Tax-Exempt Leveraged Lease Financing for the Public Sector," (New York: Goldman Sachs & Co., 1982).

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Tax Advantages

Table 10.2 presents the cash flow analysis of the transaction from the investor's perspective. Annual debt service on the IRB is $565,273. Of this amount, the interest component, which varies each year, is deductible from taxable income. Income, in the form of lease payments from the city, amounts to $585,000 annually. This amount is net of the annual ground rent due to the city from the investor. The only other cost to the investor is an annual administrative expense of $5,000. Under the "net lease" contract, it is assumed that the city retains operational control of the building together with responsibility for all maintenance, repairs, insurance, and other operating costs.

It can be seen that, after subtracting expenses, the investor has an annual before-tax cash flow of $14,727. The tax benefits are of two types. The one-time ITC is $950,000, or 20 percent of eligible renovation expenses of $4.75 million, determined by subtracting the building cost ($250,000) from the total purchase price including the contracting fee ($5 million).

The other tax benefit, depreciation, accrues annually to the investor. If the investor takes the ITC, the rehabilitated property must be depreciated using the straight-line method. The depreciable base for the property comprises the building's value (depreciated over 25 years) plus the investor's renovation expenses (depreciated over 15 years) less the value of the ITC. The value of the depreciation and the annual interest paid on the IRB are deductions from income to the investor. Towards the end of the lease period the interest component of annual debt service is less. This, plus the capital gain from the sale of the building at the end of the lease, gives the investor positive, taxable income in years 13 through 15. This shows up as a tax liability in section B of Table 10.2.

The total tax benefits of the sale-leaseback are shown in the bottom line of Table 10.2. The stream of tax benefits over the 15 years amounts to over $1.9 million, with a present value (discounted at 15 percent) of $1.2 million. These tax benefits provide the investor with an after-tax rate of return on his equity investment ($1.15 million) of more than 15 percent. This may be an adequate return, although, depending on the particular arrangement and market conditions, investors may require an after-tax return of anywhere from 15 to 30 percent.

Benefits to the Governmental Unit

Table 10.3 presents an evaluation of the sale-leaseback from the governmental unit's perspective. Since the alternate financing arrangement is the issuance of general obligation bonds, the cost of the sale-leaseback is compared to the use of conventional borrowing to pay for the renovation.

Annual lease payments, net of ground lease receipts, to the investor are set at $585,000. This expense will be offset, however, from the annual interest earnings on the escrowed sale proceeds of $1 million. This account is esti-

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TABLE 10.2
Sale-Leaseback from the Investor's Perspective

Total Price to Investors:	**$5,000,000**
Sources of Funds:	**$3,850,000 Industrial Revenue Bond** **$1,150,000 Investor Equity**

	Year 1	Year 2	Years 3–14	Year 15	Total (000's)	Net Present Value @ 15% (000's)
(A) Operating Expenses						
Rental Income	$ 585,000	$585,000	$7,020,000	$ 585,000	$8,775	$3,421
Sale Price at End of Lease	—	—	—	1,150,000	1,150	141
Administrative Expense	5,000	5,000	60,000	5,000	75	29
Debt Service on IDB	565,273	565,273	6,783,276	565,273	8,479	3,307
Income before Taxes	14,727	14,727	176,724	1,164,727	1,371	226
(B) Tax Advantages						
Tax Liability or Savings at 50% Bracket**	77,667	71,470	-11,535	-493,051*	-355	148
Investment Tax Credit	950,000	—	—	—	950	826
Total Return on Investment after Taxes (Income before taxes plus tax advantages)	-$1,042,394	$ 86,197	$ 165,189	$ 671,676	$1,965	$1,200

*includes capital gains tax

**tax on income after deductions for straight-line depreciation, administrative expenses, and interest paid on IRB

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TABLE 10.3
Sale-Leaseback from the Governmental Unit's Perspective

	Annual	15-Year Total	Present Value @ 15%
Cost of Sale-Leaseback Financing Alternative:			
(1) Lease Payments (net of ground lease)	$585,000	$8,775,000	$4,449,556
(2) Earnings from Escrow Account ($1 million invested at 11%)	110,000	1,650,000	836,669
(3) Repurchase of Building at End of Lease ($1.15 million less $1 million in escrow account)		150,000	35,909
(4) Net Cost of Sale-Leaseback	$475,000	$7,275,000	$3,648,796
Cost of General Obligation Bond Financing Alternative:			
(5) Debt Service if $4 Million, 15-Year Bonds at 10% Were Issued	$525,895	$7,888,425	$3,999,999
Savings from Sale-Leaseback:			
(G.O. debt service less total cost of sale-leaseback)	$ 50,895	$ 613,425	$351,203

mated to generate interest income of $110,000 annually (if invested at 11 percent). Annual lease payments, reduced by the amount of the interest earnings, are $475,000.

The city is expected to repurchase the building at a fair market value at the termination of the lease. Because the city has retained ownership of the land, and because land use restrictions or other restrictive covenants placed on the building limit its market value, it is estimated that the building's market value in year 15 will be $1.15 million. This amount is also equal to the investor's initial equity contribution. In year 15, the city will use the principal value of funds remaining in the escrow account ($1 million) plus $150,000 in cash to buy back the building.

The cost of traditional bond financing is shown in line five of Table 10.3. If the city were to issue general obligation (G.O.) public improvement bonds for the renovation costs, it is estimated that the average interest rate would be 10 percent. Assuming a 15-year serial bond with a level debt service structure, the annual payments would be $525,895.

It is obvious from Table 10.3 that, under these assumptions, the sale-leaseback results in a lower cost than the traditional debt financing alternative. The actual savings are given in line six. These figures are derived by subtracting line four from line five. The annual savings is estimated to be $50,895, and the total savings to be $613,425. The present value of the annual amounts saved at a discount rate of 10 percent is $351,203. As the estimated savings in present value terms is nearly 9 percent of the renovation costs, the sale-leaseback is a very attractive alternative to direct G.O. financing.

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STATEMENT OF WILLIAM B. WELSH, DIRECTOR OF LEGISLATIVE AFFAIRS, AMERICAN FEDERATION OF STATE, COUNTY, & MUNICIPAL EMPLOYEES, ACCOMPANIED BY CHARLES M. LOVELESS, LEGISLATIVE COUNSEL

Mr. PICKLE. Mr. Welsh, would you proceed?

Mr. WELSH. I am Bill Welsh, director of legislative affairs for the American Federation of State, County and Municipal Employees, a union representing over 1 million public sector workers at all levels of government throughout the Nation. With me is Charles M. Loveless, AFSCME's legislative counsel. I am testifying before this committee in support of H.R. 3110, the Government Leasing Tax Act of 1983, which would curb the use of leasing transactions by nontaxable entities including Federal, State and local governments.

I would like to have my full statement put in the record. I will summarize some of the highlights of that for you.

Mr. PICKLE. Your entire statement, Mr. Welsh, will be in the record.

Mr. WELSH. First, Mr. Chairman, I would say that AFSCME, if it thought this committee and the Congress could provide for the targeting of these tax incentives and benefits for the cities that have been described here and that are in some kind of distress, or crisis, we might have a different view of this legislation.

We support the legislation because we, in fact, believe that just the opposite may be the long-term impact of it, and that it is not possible to insure that this block of federal resources will go to those areas and jurisdictions and to those types of projects where Federal resistance is most needed. We think the beginning explosion in the use of these financing techniques is really an example of how serious the crisis in State and local governments really is across this country. That is why there is such a burst of interest with regard to using this. We think that Congress should take this signal and address the State and local fiscal problem directly and not indirectly.

There is no question that the infrastructure in this country is in trouble and needs to be rehabilitated or rebuilt; but to do that through this device, rather than through direct grant devices where you can target and define where scarce Federal resources are going, seems to us to be a very ineffective way to meet this crisis.

The second point, Mr. Chairman, I would like to make is that the long awaited recovery that we are talking about in terms of the national economy is leaving the State and local sectors of our economy behind. This is the first recession that we have had in recent years in which the State and local sector is in fact, a drag on the economy and not leading the recovery; and it is important for Congress to understand that that is going to be a major issue that has to be addressed in terms of a whole range of legislation to meet that crisis.

For example, if you are talking about a block of revenue and how to direct it, it seems to us much more significant to take those kinds of legislation that are pending in the Congress now—for example, Mr. Oberstar's bill which provides for rehabilitation and renovation of local public works and legislation providing for a revenue-sharing program that is more carefully targeted to depressed States and localities to get the kind of economic recovery and the economic stimulus that the Congress clearly wants to accomplish at the State and local level.

The third point I would like to make is that a major portion of the Federal subsidy from the leasing transactions at issue go to the private firm entering into the transaction as well as to the financial establishment negotiating the deal. Leasing transactions squander extremely scarce resources for public investment by utilizing unnecessary middlemen. And while there is no question that there has been a decline in the grant programs to State and local government, it does not mean that they are ineffective and inefficient ways of accomplishing what we want to accomplish with limited federal resources available.

Finally, Mr. Chairman, I would point out that the use of leasing transactions threaten the capacity of the public at all levels to obtain the accountability to determine where scarce resources should be allocated. If, in fact, you do not have to deal with this as an upfront budget item, or you do not have to deal with this in terms of going to the public on a bond issue, or you do not have to deal with the utilization and targeting of these resources through the legislative process of the Congress, you lose a degree of public accountability in determining how these resources are to be allocated. In the long run, we believe this is a very dangerous trend.

Thank you very much, Mr. Chairman, for the opportunity to appear before you. We hope we have indicated to you what is a very serious problem in the area of local and state financing. However, we do not believe the sale-leaseback device is an efficient and responsible way of addressing this problem. We support your legislation and hope Congress would direct its attention into these other ways of meeting the crisis.

[The parpared statement follows:]

STATEMENT OF WILLIAM B. WELSH, DIRECTOR OF LEGISLATIVE AFFAIRS, THE AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES

Mr. Chairman, I am William B. Welsh, Director of Legislative Affairs for the American Federation of State, County and Municipal Employees, a union representing over one million public sector workers at all levels of government throughout the nation. I am testifying before this Committee in support of H.R. 3110, the Government Leasing Tax Act of 1983, which would curb the use of leasing transactions by non-taxable entities including federal, state and local governments.

As public sector workers and concerned citizens, AFSCME members are particularly interested in promoting responsible and equitable public policies. AFSCME strongly endorses efforts to restrict the public sector use of leasing transactions for one simple reason—it is poor public policy. Public sector leasing transactions, like safe harbor leasing transactions, are nothing more than another raid on the Federal Treasury. These transactions allow the public sector and other not-for-profit entities to share in the substantial tax benefits which recently have been made available to the private sector for new investments. The purpose of leasing transactions is to reduce the upfront cost of public investment by exporting a portion of the cost to federal, and even state and local, taxpayers.

Although leasing transactions are still not widely used in the public sector, their increased use is being recorded almost daily in newspapers, magazines and municipal finance publications. Just recently, the Ways and Means Subcommittee on Oversight examined the growing use of leasing arrangements by the Federal Government and found that leasing was more costly than purchasing the asset directly.

It is also beginning to seem commonplace when a city announces its interest in entering into leasing arrangements for publicly owned sports arenas, sewage treatment plants and even city hall. Such transactions must be stopped now before all of the schools, city halls and other public facilities in this nation are sold to private investors.

State and local government fiscal crisis

Before discussing our reasons for supporting H.R. 3110, it should be frankly acknowledged that leasing transactions are only a symptom of the current fiscal crisis facing state and local governments. We think it is only understandable that state and local governments will us all financing methods at their disposal, including leasing transactions, to try to generate additional funds to meet their enormous public investment needs.

We urge this Committee to address the underlying reasons why state and local governments are resorting to leasing arrangements as well as other unconventional financing methods. The reasons are clear and include:

The enormous need for public investments to rebuild roads, sewers, bridges, mass transit, and other physical facilities.

The high interest rates for municipal bonds.

The grim fiscal reality facing state and local governments.

Throughout the nation, there is a growing realization of the enormous need to invest in maintaining and improving our nation's public infrastructure. The Congressional Budget Office recently reported that an additional $4 billion a year in federal spending is required through 1990 in order for the Federal Government to meet its broad responsibilities in improving our nation's physical infrastructure. Despite all this attention, sources for financing much need new public investments—at the federal and local levels—have been inadequate.

Traditionally, state and local governments finance new investments through the tax-exempt bond market. This avenue of finance has become excessively expensive. Interest rates on municipal bonds has risen dramatically in recent years jumping from an average rate of 8.6% in 1980 to 11.7% in 1982. In addition, the advantage that tax-exempt issues normally enjoy over taxable issues has been greatly eroded. In 1980, the difference in interest rates between tax-exempt and taxable issues was over 4 percentage points, while in 1982 the difference was only 2 percentage points.

The combination of the reduction in marginal tax rates, the creation of alternative tax shelters, the enactment of generous tax subsidies to business and the proliferation of industrial development bonds have brought the municipal bond market to its knees. Clearly, the huge tax subsidy that the Federal Government is paying for tax-exempt issues is not being passed on as savings to state and local governments.

State and local governments cannot afford to pay these rates. The excessive interest costs of tax-exempt financing are a real burden to state and local governments who are in the midst of a fiscal crisis unlike any since the Great Depression. Lagging tax revenues combined with steeps cuts in federal assistance have undermined the fiscal health of state and local governments throughout the nation.

Unfortunately, the arrival of the long-awaited economic recovery will prove insufficient in the near-term to heal the fiscal ills of state and local governments. Just three weeks ago, a National Governor's Association—National Association of State Budget Officers survey reported that for fiscal year 1983 state budget balances are expected to total only $346 million, or two tenths of 1 percent of current expenditures, and that if Texas were excluded the 49 state total would show a deficit. The survey indicates that the situation for fiscal year 1984 will remain grim and seven states now anticipate a deficit for fiscal year 1984.

Not only are state and local governments not able to afford to finance many needed public investments, but they are deferring required maintenance which is only adding to our nation's public infrastructure crisis.

Direct Federal assistance needed immediately

AFSCME urges this Committee not to turn its back on the real fiscal problems facing state and local governments. We recommnend that Congress take the following steps:

Provide additional revenue sharing and targeted counter-cyclical relief.

Create a grant program to meet the maintenance and construction needs of our deteriorating infrastructure, such as contained in H.R. 2554, the Emergency Public Works Employment Act of 1983, which was recently reported out of the House Public Works Committee.

Strengthen the municipal bond market by restricting the use of IDBs and by enacting a taxable bond option with direct federal subsidies to state and local governments.

Support for H.R. 3110

AFSCME supports H.R. 3110 because a careful examination of public sector leasing transactions reveals they are both an inefficient and fiscally irresponsible vehicle for providing needed federal support for public investments. While supporters of leasing transactions argue they are simply another way for the Federal Government to fund needed public investments, they fail to point out that such transactions are not a cost-effective subsidy. The major portion of the federal subsidy from leasing transactions goes to the private firm entering into the transaction as well as to the financial establishment negotiating the deal. Leasing transactions squander extremely scarce resources for public investments by utilizing unnecessary middlemen. Direct grants to state and local governments would be far more effective.

Permitting leasing transactions to fund public investments is also fiscally irresponsible. At a time of soaring federal deficits, leasing transactions represent an uncontrollable drain on the Federal Treasury. Since the federal subsidy provided by leasing transactions is passed indirectly through the tax system the Federal Government cannot limit the number of such transactions or the consequent cost to the Federal Government. In addition, public sector leasing transactions constitute an abuse of federal tax incentives which are designed for use by tax-liable entities, not tax exempt entities. These arrangements erode the federal corporate tax base by increasing the use of business deductions and credits, and they shift a disproportionate burden of federal taxation to individual taxpayers.

Widespread use of leasing transactions threatens to undermine public accountability in investment decisions. We are concerned that the Congress may be losing its capacity to determine where scarce federal resources should be allocated. There are no standards in current law to insure that such transactions further important public policies.

H.R. 3110, the Government Leasing Tax Act of 1983, is an effective way to curb the use of leasing arrangements. The stated purpose of the bill is to limit the incentives for the public sector to enter into leasing arrangements by reducing the tax benefits flowing from such transactions. H.R. 3110 seeks only to eliminate those leasing transactions which are undertaken solely for the purpose of obtaining a federal tax benefit. It preserves the ability of state and local governments to enter into leasing arrangements that present real economic advantages.

Opponents of H.R. 3110 will point out that the Federal Government has unfairly favored private investments over public investments through generous tax benefits for the private sector. Permitting the public sector to share in these benefits, it will be argued, serves to correct this problem. We do not agree that encouraging the use of leasing transactions by state and local governments is the way to correct this unfair treatment.

The problem, in our eyes, is that the current Administration has succeeded in enacting tax subsidies for indiscriminate new private investments that are far too generous. Under the current tax system, many new investments are actually more profitable after taxes than before taxes are calculated. To ensure fair treatment of public and private investments, AFSCME urges Congress to roll back the imprudent tax subsidies enacted in the Economic Recovery Tax Act to provide neutral incentives for new investment while not undermining effective taxation.

We would like to thank the Committee for this opportunity to explain AFSCME's support for H.R. 3110. We would be pleased to respond to any questions you may have.

Chairman Rostenkowski. Are there any questions?

Mr. Pickle will inquire.

Mr. Pickle. Thank you for your testimony. It seems to me there is a split of opinion in your group. I am glad there is. Ms. Spain, I appreciate the fact that your organization is going to meet soon to make a decision whether they would endorse or make some policy with reference to the bills. Your organization in the past has been, as I recall it, apprehensive about the indiscriminate use of these industrial development bonds, and you said it was a questionable practice.

At least use for private purposes has caused the bond market to advance as far as traditional tax-exempt programs.

Mr. Welsh just got through saying, if I remember, the average rate has jumped from 8.6 in 1980 to 11.7 in 1982. At least 2½ percent. I presume you assume from that—although there may be other factors—the primary reason is that there is such a heavy use of the IDB's that they lose their appeal when you compare them to a regular IDB program. Thus, the regular tax-exempt program is dissipating or becoming more expensive for you, if, indeed, you could even find it possible to draw the lines.

I would hope your organization would keep in mind this committee is not trying to establish new policies to do new damage to our cities.

Ms. Kourouma, you wanted us to be sure we stop this bill so it would save our cities; and some of us who are trying to advance this bill are trying to do it because we want to save our country. I guess we have to look at it in our own way. I am not critical about anybody's position. I think everybody ought to be heard.

One of you made the point you ought to have a right to be heard about transition dates. I accept that. We will do that. I am glad to hear your testimony. But I appreciate the fact that you would express yourself.

I particularly appreciate the fact, Mr. Welsh, that you would come in on behalf of your organization and testify. Mr. Welsh has been with us here in Government for many a year and has been a top official in previous administrations and rendered a great service. So, your testimony from your organization will be very useful to us.

I thank you all.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you, Mr. Chairman.

I would like to thank all the panelists for their testimony, and particularly commend Mr. Welsh for his testimony, with which I very much agree. I can understand the position of the cities trying to get all the help they can. I was assuming, Ms. Kourouma, from your testimony, that you have seen a dramatic change in the last 2 years in the amount of money being pumped into cities for rehabilitation; is that correct?

Ms. KOUROUMA. Right.

Mr. PEASE. You think it would be a mistake to take the law back to where it was 2 years ago?

Ms. KOUROUMA. No. We would just like the municipalities to have the same benefit, the same access to the tax credit that private corporations have, so that they can amass the capital they need to improve infrastructure. There are direly needed projects in the cities.

Mr. PEASE. I know that you would think—and I would agree with you—that cities need all the help they can get from all resources to confront the multitude of problems facing cities; but, as you know, we have a Federal deficit of about $200 billion facing us for the next 8, 10 years probably. That is going to put enormous pressure on the Congress to shed itself of responsibilities which are not a primary Federal responsibility.

Federal revenue sharing for citizens is certainly not a primary Federal responsibility. If it came down to it, and you were asked to make a choice between this provision and Federal revenue sharing, which would you think would be best for the cities to retain?

Ms. **Kourouma**. I don't understand why we would necessarily have to make a choice. People seeking tax shelters—there is only a limited amount of investment capital available. People will find tax shelters, and—anyway. I would certainly want them to use those tax shelters to benefit the public rather than some foreign country, which is being done now to a large extent, which will probably continue.

Certainly, I would like them to have the option of using it for public purposes.

Mr. **Pease**. Our purpose on this committee is to close off the avenues for tax shelters as much as we can, so that people put their money into a taxable investment and pay the taxes on them, contribute to the operation of the Nation, so that we can reduce the deficit and afford to retain programs like Federal revenue sharing.

Ms. **Kourouma**. We certainly want that. We certainly want revenue sharing. I think there is no question about that. I guess I don't understand the conflict.

Mr. **Pease**. Well, you are trying to defeat the entire bill; at least, I think you said you were opposed to the entire bill. We heard testimony this morning from the Treasury Department that there are $2 trillion worth of assets available to be sold and leased back. That would take advantage of this law.

Obviously, there are not that many people in high-income tax brackets to take advantage of it; but if 1 percent did, 1 percent, that would be $200 billion and the loss to the Treasury might be $30, $40 billion from that. Presuming that we have to make that up somehow, don't you think it would be a bad trade, if we would say, Well, all right, $30 billion in the red, we will just shunt ourselves of this responsibility called revenue sharing which really is not our responsibility anyhow?

Ms. **Kourouma**. I would like Mr. Gross to respond to that.

Mr. **Gross**. If I could, the assumption the committee has been operating under with the help from the Treasury this morning is that this $2 trillion of assets is going to attract more investment that will drain the Treasury. We think that is wrong. There is a certain amount of investment capital that will find shelters. You can read any tax sheltering magazine, the dozens that are published. People are investing in llamas in Peru, avocados, figs in California.

What our clients are saying, what the Conference of Black Mayors is saying, is that limited amount of investment dollars which you have agreed, in the tax laws, will be available for shelter ought to go to productive public shelter purposes, instead of being used to invest in llamas in Peru and beans in California.

There is no projected drain on the Treasury. The $2.2 trillion is a phony number with all due respect to the Treasury. There is a certain amount of investment capital. Those investors are very intelligent and sophisticated. They are going to find shelters.

The question for the committee is: Do they find shelter with the committee's help in productive investment, in productive public and educational investment or in these unproductive tax shelter abuses? There is nothing before the committee to shut off investment in Peruvian llamas. There is a bill before the committee to shut off investment in our citizens and colleges.

I think that is the choice the committee ought to be focusing on, not on additional revenue drains. There is no evidence of any additional revenue drain from this practice.

Mr. **Pease**. What evidence do you have that some of these investments are no longer flowing into Peruvian llamas? In other words, what tax shelters that were used prior to 1981 are no longer now being solicited and invested in?

Mr. **Gross**. It is not a question of what is no longer being solicited, sir. It is a question of what the competitive attractiveness is of various investments. An investor may buy in the open market. If he can buy a 15-year public municipal property versus a 5-year llama, it is not clear which he will choose.

But it is clear to me if you can buy a 15-year private building or a 30-year public building, he will most likely choose the 15-year private building. He will get his shelter no doubt. You will have paid for that through the existing tax laws.

The question is whether you want to use some of what you have agreed to pay for in a public and beneficial way. I think there is still no evidence before this committee of any drain on the Congress from this—on the Treasury from this approach. It is merely an allocation of limited and scarce investment dollars which are going to find their shelter and are very effective at doing so under the 1981 Tax Act.

Mr. **Pease**. If you could provide the committee with something other than an assertion that there will not be a loss of revenue, it certainly would be appreciated.

Mr. **Gross**. We will be happy to submit additional material, including some of the tremendously abusive shelters that are being offered on Peruvian animals.

Mr. **Pease**. I will grant you there are other shelters out there. I want from you evidence that there will not be any loss of revenue, but merely a shifting from one shelter to another.

Mr. **Gross**. We would be pleased to do so.

Mr. **Pease**. Thank you.

[The information was not received.]

Chairman **Rostenkowski**. Thank you very much.

The Chair calls Mr. Oosterhuis, Mr. Zimmerman, Mr. Gatton, and Mr. Hendrickson.

STATEMENT OF PAUL W. OOSTERHUIS, COUNSEL, COMPUTER AND BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION

Mr. **Oosterhuis**. Good morning. My name is Paul W. Oosterhuis. I am appearing today on behalf of the Computer and Business Equipment Manufacturers Association [CBEMA], an association composed of approximately 42 manufacturers of computer systems, sophisticated business equipment and other high technology electronics products. I appreciate this opportunity to appear before the Ways and Means Committee to discuss H.R. 3110.

The bill as introduced would have a major impact on those CBEMA members which in the ordinary course of their business lease computers and other business equipment which they manufacture to Federal, State, or local governments, hospitals, educational and charitable institutions, and other tax-exempt entities. These leases are offered by CBEMA members as an alternative to purchase and are preferred by many customers for various reasons such as service, replaceability, and budget which are unrelated to tax-benefits.

H.R. 3110 was introduced to carry out recommendations made by the Ways and Means Oversight Subcommittee after its review of the impact of ACRS and the investment credit on leasing to tax-exempt entities. The subcommittee's report concluded that in certain circumstances tax incentives exist which can lead tax-exempt entities to lease rather than own equipment.

H.R. 3110 attempts to eliminate this incentive primarily by increasing the time period over which the costs of equipment leased to tax-exempt entities can be recovered. The bill also denies the investment credit for leases to foreign governments and speaks generally to the issue of when an arrangement constitutes a lease versus a service contract for investment credit purposes. These latter two changes are, however, of less importance to CBEMA members. Our comments today will be limited to the bill's changes to ACRS. Under these changes equipment costs which can now be recovered over 5 years on a slightly accelerated basis must be recovered over 12 years on a straightline basis.

Because the bill applies to all ACRS equipment, we believe H.R. 3110 goes substantially further than is necessary to accomplish its intended purpose. In the case of equipment which is leased to tax-exempt entities, and is therefore not eligible for the investment credit, a tax incentive to lease rather than purchase can result only if the equipment is sufficiently long-lived that it can be leased on a long-term basis using long-term debt financing. However, computers and other similar business equipment are in fact short-lived assets. The rate of technological innovation which has existed in this industry since the 1960's rapidly causes equipment which might remain mechanically usable to be technologically obsolete or at least uncompetitive with newer equipment. For these kinds of equipment, 5 years is a very long time. It is unusual for the lease terms of computers and other similar business equipment to run for more than 5 years. They often are as short as 2 years. These short lease terms reflect the underlying short useful life of the equipment.

The asset depreciation range [ADR] system, under which equipment could be depreciated prior to the advent of ACRS, established a 6-year midpoint life for computers, data processing, copying, and other similar equipment. In this ADR class, taxpayers could depreciate computers and other similar business equipment over 5 years utilizing a double declining balance method. For these taxpayers the enactment of ACRS gave rise not to an increase but to a decease in the cost recovery deductions available for computers and other similar equipment. The enactment of ACRS actually reduced any incentive for tax-exempt entities to lease computer equipment. It did not create any new incentives which could lead to abuse.

Because the level of tax benefits of short-lived equipment such as computers and other business equipment is small and because leases of this equipment are entered into for nontax reasons, we believe that any provisions adopted by this committee intended to eliminate any incentive established in ACRS for taxexempt entities to lease rather than purchase equipment should exclude short-lived equipment. Such an exclusion should apply to any equipment which under ADR could have been depreciated over a period not greater than that equipment's ACRS period. Under this rule, equipment in the ACRS 5-year category would be excluded, where under ADR taking into account the range of acceptable depreciation periods the equipment could have been depreciated over 5 or fewer years. Similarly, equipment in the ACRS 3-year category would be excluded, where under ADR the equipment could have been depreciated over 3 or fewer years. We prefer this approach to the problem of short-lived equipment to an approach under which all equipment would be depreciated over some useful life such as ADR that attempts to reflect actual or economic depreciation. While this latter rule may well make sense for some longer-lived equipment, for short-lived equipment little will be gained. Further, to the extent some differences result in tax benefits between the new system and ACRS, lessors of computer and other similar equipment would be required to establish an additional category of lease rates for leases to tax-exempt entities. We would strongly prefer to avoid the burden involved in establishing a new category.

An exclusion of short-lived equipment from the modifications to ACRS in H.R. 3110 would not in any way detract from the overall goals intended to be accomplished by H.R. 3110. It would merely prevent that legislation from unnecessarily penalizing owners of short-lived equipment which lease to tax-exempt entities. Thank you.

[The prepared statement follows:]

STATEMENT OF PAUL W. OOSTERHUIS, ON BEHALF OF THE COMPUTER AND BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION

My name is Paul W. Oosterhuis. I am a partner in the Washington law firm of Hogan & Hartson. I am appearing today on behalf of the Computer and Business Equipment Manufacturers Association ("CBEMA"), an association composed of approximately 42 manufacturers of computer systems, sophisticated business equipment and other high technology electronics products. I appreciate this opportunity to appear before the Ways and Means Committee to discuss H.R. 3110.

The bill as introduced would have a major impact on those CBEMA members which in the ordinary course of their business lease computers and other business equipment to federal, state, or local governments, hospitals, educational and charitable institutions, and other tax-exempt entities.

H.R. 3110 was introduced to carry out recommendations made by the Ways and Means Oversight Subcommittee after its review of the impact of ACRS and the investment credit on leasing to tax-exempt entities. See Subcommittee on Oversight, Committee on Ways and Means, "Tax and Budget Issues Relating to Leasing by Nontaxable Entities," WMCP:98-7, May 25, 1983. That Subcommittee's report concluded that under certain tax rules, an incentive often exists that causes tax-exempt institutions to lease (rather than own) equipment where the lessor of the equipment is eligibile for the investment credit and ACRS. The Subcommittee also concluded that under certain more limited circumstances an incentive to lease rather than own exists even when no investment credit is available.

Since tax-exempt entities generally pay no federal income tax, the federal income tax rules can create a situation where such institutions lease equipment from taxpayers rather than own the equipment themselves where negative tax rates exist with respect to the equipment. A negative tax rate means that the after-tax rate of return on an investment exceeds the before-tax rate of return. When such a situation exists, taxpaying entities can obtain the larger after-tax rate of return by owning property. However, the rate of return can be obtained by tax-exempt entities only if they lease property from taxpaying entities and if the tax benefits attributable to the equipment are substantially passed through to the lessee in the form of reduced rents.

H.R. 3110 attempts to eliminate any incentive for tax-exempt entities to lease rather than own equipment primarily by increasing the time period over which the costs of such equipment can be recovered.[1] For example, equipment costs which can be recovered over five years on a slightly accelerated basis under ACRS would be required to be recovered over twelve years on a straight-line basis under the bill. The bill applies to all equipment which is ACRS recovery property and is used by tax-exempt entities unless the use is pursuant to a "casual or short-term lease." The bill does not specify what constitutes a casual or short-term lease for this purpose. However, we assume that where the term of a computer and other business equipment lease runs for a substantial portion of the actual useful life of the equipment, that equipment is subject to the requirements of H.R. 3110.

By requiring that the recovery period for *all* ACRS equipment be lengthened substantially, we believe H.R. 3110 goes substantially further than is necessary to accomplish its intended purpose. In the case of equipment which is leased to tax-exempt entities and is therefore not eligible for the investment credit, negative tax rates (and any tax incentive to lease rather than purchase) generally do not exist. Such negative tax rates can result only when the tax benefits attributable to any equipment exceed the benefits of expensing, and ACRS without the investment credit is clearly much less generous than expensing. However, if the equipment is financed with debt, giving rise to interest deductions offsetting a substantial portion of rental income, the ACRS benefits on such equipment can be sufficiently more generous than expensing to make leasing more attractive than owning.

The problems of debt-financed equipment leasing most often occurs in the context of leveraged leases which are packaged and sold to investors. By contrast, CBEMA members are companies which manufacture equipment products primarily for sale to customers. In this context, when CBEMA members offer equipment leases to customers, the leases are not directly debt financed. Moreover, leasing is offered as an alternative to purchase not because of tax benefits, but because some customers (including tax-exempt entities) prefer leasing for business reasons unrelated to tax benefits. First, by leasing rather than purchasing equipment a user can effectively shift the risks relating to the value of the equipment at the end of the lease term (the so-called "residual value") to the lessor. This means that users need not be concerned whether at the end of the lease term they own technologically obsolete equipment. Second, leasing in effect provides users with 100 percent financing of the leased equipment, often at relatively favorable rates (compared to taxable debt financing). Thus, whether the user is a taxable or tax-exempt entity, the leasing transactions of CBEMA members are not directly debt financed and are undertaken without regard to any differences in the tax consequences of the form chosen. But, even where direct debt financing does exist, the required level of tax benefits to cause an incentive to lease is not present with respect to all equipment. Sufficient tax benefits can only be obtained (assuming relatively stable rents throughout the lease period) if the useful life of the property (which ultimately limits the term of the loan and the lease) significantly exceeds the ACRS period for the property. In such cases ACRS recovery deductions can be accelerated to the point where they are received sufficiently in advance of the rental payments used to repay the loan that a substantial deferral of tax results and provides increased tax benefits to the lessor. However, where the useful life of the property does not significantly exceed the period over which its costs is recovered under ACRS, negative tax rates and the accompanying incentive to lease are not created.

The above analysis was adopted implicitly by the Oversight Subcommittee when it made its recommendations that Congress should reexamine the cost recovery deductions permitted to certain property leased to nontaxable entities. In its report (at page 17) the Subcommittee stated (as its heading to its recommendation): "Congress should examine cost recovery deductions for lessors who enter into *long-term lease transactions* or other similar transactions with the Federal Government or other nontaxable entities[.]" [Emphasis added.] Yet, H.R. 3110 is not limited to long-lived assets or long-term lease transactions.

Computers and other similar business equipment are in fact short-lived assets. The rapid rate of technological innovation which has existed in this industry since the 1960's cause equipment which might remain mechanically usable to be technologically obsolete or at least noncompetitive with newer equipment. For these kinds of equipment, five years is a very long time. For this reason, it is unusual for the term of leases of computers and other similar business equipment to run for more than five years. They often are as short as two years. These short-lease terms reflect the underlying short, useful life of the equipment.

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[1] The bill also denies the investment credit for leases to foreign governments and speaks generally to the issue of when an arrangement constitutes a lease versus a service contract for investment credit purposes. These two changes are of less importance to CBEMA members.

The asset depreciation range (ADR) system, under which equipment could be depreciated prior to the advent of ACRS, established a six-year midpoint life for computers, data processing, copying and other similar equipment (*see* Asset Guideline Classes 00.12 and 00.13 in Revenue Procedure 77-10, 77-1 C.B. 568). Thus, in this ADR class equipment could be depreciated over five, six or seven years utilizing the double-declining balance method. In fact, under ADR many taxpayers did depreciate their computers and other similar equipment over five years. Others chose to depreciate equipment over seven years, but did so primarily to obtain a larger investment credit (10 percent rather than 6.67 percent).

Because under ADR taxpayers could and did depreciate computers and other similar business equipment over five years utilizing a double declining balance method, the enactment of ACRS cost recovery (without regard to the investment credit changes in either the 1981 or 1982 Acts) gave rise not to an increase but to a decrease in the cost recovery deductions available to owners of computers and other similar equipment. The table below shows that, at any relevant discount rate, the present value of tax benefits attributable to ACRS is significantly less than the tax benefits available to taxpayers who under ADR were depreciating equipment over five years utilizing the double declining balance method.

COMPARISON OF PRESENT VALUE OF ADR AND ACRS (FOR PROPERTY DEPRECIATED OVER 5 YEARS UNDER ADR AND ACRS)

	ADR	ACRS
Discount rate:		
0	46.00	46.00
6	40.59	39.64
8	39.04	37.83
10	37.61	36.18
12	36.26	34.63
14	35.00	33.20

As the above table indicates, the change from ADR to ACRS did not give rise to any new tax benefits which could create a potential for abuse involving the lease of computers or other similar business equipment to tax-exempt entities. Indeed, the change in fact reduced the tax benefits for such equipment for all leases to tax-exempt entities.

Indeed, even in leveraged computer leasing transactions little if any "tax shelter" is generated. Since lease terms for computers and other similar equipment are generally five years or less, loan terms are generally limited to similar periods of time. Computer leases, like other leases, generally provide for relatively even rents during the five-year time period. Thus, the only tax deferral that exists arises because ACRS is slightly accelerated and because loans will likely be level payment loans, under which increasing payment portions are allocated to principal in later years. Thus, under ACRS even with substantial debt financing the only tax benefits obtained in leases of computers or other business equipment involve small amounts of deferral for short periods of time.

Because the level of tax benefits of short-lived equipment such as computers and other business equipment is small and because leases of this equipment are entered into for non-tax reasons, we believe that any provisions adopted by the Ways and Means Committee intended to eliminate any incentive established in ACRS for tax-exempt entities to lease rather than own equipment should be limited to those situations where such an incentive clearly exists. We thus urge that short-lived equipment be excluded from the rules of H.R. 3110 requiring the use of longer-than-ACRS lives for leases to tax-exempt entities. Such an exclusion should apply to any equipment which under ADR could have been depreciated for a period not greater than that equipment's ACRS period. Under this rule, equipment in the ACRS five-year category would be excluded, where under ADR (taking into account the range of acceptable depreciation periods) the equipment could have been depreciated over five or fewer years. Similarly, equipment in the ACRS three-year category would be excluded, where under ADR the equipment could have been depreciated over three or fewer years.

We believe the above approach is a solution to the problem of short-lived equipment that is superior to an approach under which all equipment would be depreciated under some life (such as ADR) that attempts to reflect actual or economic depreciation. While the latter rule may well make sense for some longer-lived equipment, for short-lived equipment little will be gained. For example, for computers and other business equipment, a shift in depreciation from five-year ACRS to six-year ADR (with double declining balance) would not have a major impact. However, such a shift would not accomplish any necessary goal and would require a separate system of accounting for assets leased to tax-exempt institutions. Further, to the extent some differences result in tax benefits between ADR and ACRS, lessors of such equipment would be required to establish an additional category of lease rates (in addition to rates for taxable entities where the investment tax credit is or is not passed through to the entities).

An exclusion of short-lived equipment from the modifications to ACRS in H.R. 3110 would not in any way detract from the overall goals intended to be accomplished by the legislation. It would merely prevent that legislation from unnecessarily penalizing owners of short-lived equipment which lease to tax-exempt entities.

Chairman ROSTENKOWSKI. Mr. Zimmerman you may proceed.

STATEMENT OF MARTIN E. ZIMMERMAN, PRESIDENT, LEASE INVESTMENT CORP.

Mr. ZIMMERMAN. I am Martin Zimmerman. I am here to testify on certain aspects of H.R. 3110 which relate to leasing for not-for-profit hospitals. My purpose in speaking to you is to present certain facts which I hope will demonstrate that leasing to not-for-profit hospitals has not been subject to the excesses which are attributable to leasing to tax-exempt organizations generally, and also to demonstrate that there are good and logical reasons for exempting hospitals from provisions of H.R. 3110.

Hospital equipment leasing has been in existence over 15 years, and its primary purpose has been to transfer the risks of equipment obsolescence outside the health care field.

My company, Lease Investment Corp. has been in business for 8 years and is one of the leaders in this specialized field. In addition, I am associated with the Association of Equipment Lessors [AAEL] as a member of their tax committee. We underwrite taxable financing, and a significant part of the time keep whatever tax benefits which may exist for our own account.

Our company also buys and sells used hospital equipment, particularly high technology radiology equipment such as CT scanners, ultrasound equipment and nuclear cameras for the diagnosis of cancer. Such used and off-lease equipment is typically sold to small community hospitals, physicians groups in rural areas, or abroad, to Latin America and elsewhere. This equipment recycling function is practiced by many of the lessors specializing in hospital equipment.

Here are a few facts relative to equipment leasing to not-for-profit hospitals:

Hospital equipment leasing has been in existence since the late 1960's.

The major incentive to hospital leasing is the transference of the risk of equipment obsolescence.

Current market size, other than leasing by manufacturers of their own equipment, is about $300 million per year. This has increased at a modest, rather than accelerated rate, due to competition from tax-exempt bond and tax-exempt equipment note financing. The amount of revenue which would be raised by applying H.R. 3110 to hospitals would not be large compared to the resultant loss of capital raising capability by certain not-for-profit hospitals.

Virtually all hospital equipment leasing is financed with taxable loans. Sale/leasebacks using tax-exempt debt are virtually nonexistent.

A considerable number of not-for-profit private hospitals which are categorized as "tax-exempt" under the IRS Code cannot borrow on a tax-exempt basis because of restrictions in their State hospital bond authorities or because they are not sufficiently creditworthy.

Most hospital leases are for high-technology equipment and leases are usually of 5-year duration. This is the expected useful life of CT scanners, nuclear diagnostic, and ultrasound equipment, which are representative of the items of equipment leased.

Prior to ACRS depreciation, 5-year facts and circumstances depreciation was the most frequent choice. Many types of hospital equipment become obsolete long before the 9-year ADR guideline life is reached.

Finally, there is an unmistakable trend among not-for-profit hospitals toward the formation of holding companies with for-profit subsidiaries to finance equipment. This leased equipment would qualify for both 5-year ACRS and the investment tax credit.

Passage of the proposed bill is likely to dramatically accelerate this trend. Thus, it would appear that lost revenue from investment tax credits associated with this shift to for-profit status could far exceed any new revenue generated from H.R. 3110 for not-for-profit hospitals.

We, therefore, respectfully request your consideration for deleting not-for-profit hospitals from the provisions of H.R. 3110 other than in instances where tax-exempt debt is not used in connection with the acquisition of the property.

Thank you.

[The prepared statement follows:]

Statement of Martin E. Zimmerman, President, Lease Investment Corp.

Thank you for the opportunity of testifying on certain aspects of HR-3110 which are related to leasing to not-forprofit hospitals. My purpose in speaking to you is to present certain facts which I hope will demonstrate that leasing to not-for-profit hospitals has not been subject to the excesses which are attributable to leasing to tax-exempt organizations generally, and also to demonstrate that there are good and logical reasons for exempting hospitals from provisions of HR-3110.

Hospital equipment leasing has been in existence over 15 years, and its primary purpose has been to transfer the risks of equipment obsolescence outside the healthcare field.

My company, Lease Investment Corporation, has been in business for eight years and is one of the leaders in this specialized field. In addition, I am associated with the Association of Equipment Lessors (AAEL) as a member of their Tax Committee. Our company acts in the capacity of a "lease investment banker." We recommend to our hospital client whichever type of financing proves to be the least expensive, whether it is a leveraged lease, taxable installment loan, or tax-exempt debt. We underwrite taxable financing, and a significant part of the time keep whatever tax benefits which may exist for our own account.

Our company also buys and sells used hospital equipment, particularly high technology radiology equipment such as CT scanners, ultrasound equipment, and nuclear cameras for the diagnosis of cancer. Such used and off-lease equipment is typically sold to small community hospitals, physicians groups in lightly populated areas, or abroad, to Latin America and elsewhere. This equipment recycling function is practiced by many of the lessors specializing in hospital equipment.

The procedure followed in a hospital equipment lease is relatively predictable. The hospital chooses the equipment. If leasing is determined to be the least costly alternative over the usual five to seven year useful life of the asset in the hospital environment, bids are requested and a contract is entered into. The lessor may be the equipment manufacturer, a bank or an independent lessor.

In virtually every case the equipment is paid for by the lessor, and the debt, if any, which is associated with the financing is taxable debt. This is a significant departure from leasing that is done with other tax-exempt entities. Hospital authority bond indentures forbid the sale of assets financed with tax-exempt debt.

Here are a few facts relative to equipment leasing to not-for-profit hospitals:

Hospital equipment leasing has been inexistence since the late 1960s. It has grown at a rate about consistent with the sales of equipment to the industry (i.e., 8 percent to 12 percent per year).

The major incentive to hospital leading is the transference of the risk of equipment obsolescence.

Current market size (other than leasing by manufacturers of their own equipment) is about $300 million per year. This has increased at a modest, rather than accelerated rate, due to competition from tax-exempt bond and tax-exempt equipment note financing. The amount of revenue which would be raised by applying HR–3110 to hospitals [1] would not be large compared to the resultant loss of capital raising capability by certain not-for-profit hospitals.

Virtually all hospital equipment leasing is financed with taxable loans. Sale/leasebacks using tax-exempt debt is virtually non-existent, due to the restrictive bond indentures common to tax-exempt financing in the healthcare field.

A considerable number of not-for-profit private hospitals which are categorized as "tax-exempt" under the IRS Code, do not or cannot economically borrow on a tax-exempt basis because of restrictions in their state hospital bond authorities or because they are not sufficiently credit-worthy.

Most hospital leases are for high-technology equipment and leases are usually of five year duration. This is the expected useful life of CT scanners, nuclear diagnostic and ultrasound equipment, which are representative of the items of equipment leased.

Prior to ACRS depreciation, five year Facts and Circumstances Depreciation was the most frequent choice. Many types of hospital equipment become obsolete long before the nine year ADR Guideline life is reached.

A major service provided by most hospital equipment lessors is to remarket used and off-lease, high-technology medical equipment, thus reducing the net cost of use to the original hospital lessees.

Many not-for-profit hospitals are forming holding companies and for-profit subsidiaries to be able to finance equipment on a more equal basis with for-profit (proprietary) hospitals. Passage of the proposed Bill is likely to dramatically accelerate this trend and at the same time increase related legal and accounting expenses.

The proposed Bill, in its present form, would cause the cessation of most equipment leasing to not-for-profit hospitals. It would increase the cost of use of high-technology equipment, particulary on a five year or shorter-term basis.

We believe that hospital equipment leasing is a special area which has neither achieved the size nor experienced the excesses observed in leasing to states, municipalities and other not-for-profit areas. Further, the equipment is of a much higher technological content and the availability of ACRS or a comparable depreciation policy is essential to the continued transference of the risks of obsolescence to third parties.

We respectfully request your consideration of deleting not-for-profit hospitals from the provisions of HR–3110, so long as tax-exempt debt is not used in connection with the initial acquisition of the property.

Thank you for granting me the opportunity to speak to you. I would be pleased to answer any questions you may have.

Mr. PICKLE [presiding]. Next is Mr. Gatton.

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[1] Estimated to be $10 million the first year and $22 to $25 million the second through fifth years.

STATEMENT OF DAVID GATTON, EXECUTIVE SECRETARY, NATIONAL RESOURCE RECOVERY ASSOCIATION, U.S. CONFERENCE OF MAYORS

Mr. GATTON. Mr. Chairman, I am David Gatton, executive secretary of the National Resource Recovery Association, an affiliate of the U.S. Conference of Mayors. The association is a group of over 150 local jurisdictions and private firms which are in the process of developing waste-to-energy projects and district heating and cooling facilities. These facilities represent urban America's major energy and waste disposal infrastructures. We are very concerned about the negative effects H.R. 3110 would have on project development across the country.

Urban waste-to-energy projects represent our Nation's major alternative to landfills for the disposal of municipal refuse. The United States generates over 150 million tons of garbage annually and it is essential that local governments develop with the private sector alternative means for disposal before our ground water is further polluted.

Currently, about 50 jurisdictions have operating resource-recovery facilities; another 50 are actively developing projects, and 100 more are in initial planning. District heating and cooling (DHC) is a system of delivering hot or cold water or steam from a central thermal source through pipes to customers for space heating and cooling and industrial processes. Over 40 American cities use district heating and several private firms have plans to either rehabilitate or expand these systems to more modern hot water technology.

H.R. 3110 appears to be precipitated by certain sale-leaseback and other arrangements that have recently come to the committee's attention. However, the actual provisions of the bill will go far beyond that and stop many worthwhile public/private projects, especially in the resource recovery field.

Typically, in a large-scale municipal waste-to-energy facility, a private vendor or owner enters into a service contract arrangement with participating local governments. In exchange for the localities' commitment to deliver their solid waste to the facility and sometimes to buy steam, the private owner promises to provide an important waste disposal service in an efficient and environmentally safe manner.

These arrangements are subject to hard bargaining and the private participant undertakes significant financial commitments and incurs real risks. These private sector risks include: Guarantees to construct the facility within certain cost parameters and in a timely fashion; to successfully test the technology and keep the facility open and functioning; and to attract other private and public solid waste and steam or electricity customers.

The private sector has been involved with cities in resource projects for at least 10 years in the United States. The private sector ownership of resource recovery facilities brings specialized expertise to bear and relieves cities of significant risks.

In addition, the existence of tax benefits allow the private sector to be involved in these projects and shifts a substantial portion of the capital cost from public sector financing to private sector equity contributions. All these benefits of traditional private sector involvement help financially strapped cities to lessen their dependence on scarce landfill space and develop infrastructures that create jobs and economic growth.

H.R. 3110 threatens the viability of these traditional public/private arrangements by applying an amorphous and restrictive concept of "tax-exempt use" to the eligibility for ACRS and the ITC. Present tax law disallows the ITC when the property in question is used by a governmental entity. However, the IRS and the courts have recognized an exception for service contracts, where private firms provide services to tax-exempt organizations versus a lease wherein the tax-exempt entity provides a service to itself.

The service contract/lease distinction developed under section 48(a) (4) and (5) already is so unclear that cities must incur exorbitant expenses for legal services and suffer delays in resource recovery construction. This concept will be dangerously muddied further by the addition of a kind of possessory and economic control and interest balancing test to determine whether a service contract exists.

What will result is nothing more than a case-by-case IRS discretion that will delay or stop many projects and raise expensive legal fees for all parties. The resource recovery field already faces this disruptive situation under 48(a) (4) and (5), and the proposed lease/service contract provision would only exacerbate matters.

In addition, industrial development bond-financed real property seems to be singled out for special treatment in this bill. As part of TEFRA, last year Congress considered at length continued use of IDB's and ACRS and explicitly excluded municipal solid waste disposal from restrictions. This allowed resource recovery facilities to retain tax benefits roughly commensurate with those available prior to the Economic Recovery Tax Act of 1981.

We in the field thought that this issue had been put to rest last summer, and we have planned accordingly. It would be unfair to change the rules on us again.

In closing, let me give an example of how the distinction between a service contract and a lease if it were destroyed would affect a typical project. In Detroit, Mich., the tipping fee for the proposed waste energy facility there would raise from $12.03 to $21.25 per ton, an increase of 77 percent. The size of Detroit's bond issue would increase 35 percent and our calculations on other projects have shown that essentially the same result would occur. Tipping fees overnight would be increased 100 percent.

In total, we think this unprecedented cost increase would halt many projects and certainly in Detroit's case and other cities, 5 to 8 years of development would go down the drain.

In summary, we think a lot of projects would be stopped and our ability to negotiate would be damaged.

Thank you.

[The prepared statement follows:]

STATEMENT OF THE U.S. CONFERENCE OF MAYORS' NATIONAL RESOURCE RECOVERY ASSOCIATION

Mr. Chairman, I am David Gatton, Executive Secretary of the National Resource Recovery Association, an affiliate of the U.S. Conference of Mayors. The Association is a group of over 150 local jurisdictions and private firms which are in the process of developing waste-to-energy projects and district heating and cooling facilities. These facilities represent urban America's major energy and waste disposal infrastructures. We are very concerned about the negative effects H.R. 3110 would have on project development across the country.

Urban-waste-to-energy projects represent our nation's major alternative to landfills for the disposal of municipal refuse. The United States generates over 150 million tons of garbage annually and it is essential that local governments develop with the private sector alternative means for disposal before our groundwater is further polluted. Currently, about 50 jurisdictions have operating resource recovery facilities; another 50 are actively developing projects, and 100 more are in initial planning. District heating and cooling (DHC) is a system of delivering hot or cold water or stream from a central thermal source through pipes to customers for space heating and cooling and industrial processes. Over 40 American cities use district heating and several private firms have plans to either rehabilitate or expand these systems to more modern hot water technology.

H.R. 3110 appears to be precipitated by certain sale-leaseback and other arrangements that have recently come to the Committee's attention. However, the actual provisions of the bill will go far beyond that and stop many worthwhile public/private projects, especially in the resource recovery field. We are here to let the Committee know about these adverse effects.

Typically, in a large-scale municipal waste-to-energy facility, a private vendor or owner enters into a service contract arrangement with participating local governments. In exchange for the localities' commitment to deliver their solid waste to the facility, and sometimes to buy steam, the private owner promises to provide an important waste disposal service in an efficient and environmentally safe manner. These arrangements are subject to hard bargaining, and the private participant undertakes significant financial commitments and incurs real risks. These private sector risks include guarantees to construct the facility within certain cost parameters and in a timely fashion; to successfully test the technology and keep the facility open and functioning; and to attract other private and public solid waste and steam or electricity customers.

The private sector has been involved with cities in resource projects for at least ten years in the U.S. The private sector ownership of resource recovery facilities brings specialized expertise to bear, and relieves cities of significant risks. In addition, the existence of tax benefits allow the private sector to be involved in these projects and shifts a substantial portion of the capital cost from public sector financing to private sector equity contributions. All these benefits of traditional private sector involvement help financially strapped cities to lessen their dependence on scarce landfill space and develop infrastructures that create jobs and economic growth.

H.R. 3110 threatens the viability of these traditional public/private arrangements by applying an amorphous and restrictive concept of "tax-exempt use" to the eligibility for ACRS and the ITC. Present tax law disallows the ITC when the property in question is used by a governmental entity. However, the IRS and the courts have recognized an exception for service contracts, where private firms provide service to tax-exempt organizations versus a lease wherein the tax-exempt entity provides a service to itself. The service contract/lease distinction developed under Section 48(a) (4) and (5) already is so unclear that cities must incur exorbitant expenses for legal services and suffer delays in resources recovery construction. This concept will be dangerously muddied further by the addition of a kind of possessory and economic control and interest balancing test to determine whether a service contract exists. What will result is nothing more than unbridled case-by-case IRS discretion that will delay or stop many projects and raise expensive legal fees for all parties. The resource recovery field already faces this disruptive situation under 48(a) (4) and (5), and the proposed lease/service contract provision would only exacerbate matters.

In addition, industrial development bond-financed real property seems to be singled out for special treatment in this bill. As part of TEFRA, last year Congress considered at length continued use of IDBs and ACRS and explicitly excluded municipal solid waste disposal from restrictions. This allowed resource recovery facilities to retain tax benefits roughly commensurate with those available prior to the Economic Recovery Tax Act of 1981. We in the field thought that this issue had been put to rest last summer and we have planned accordingly. It would be unfair to change the rules on us again.

With the loss of ACRS and ITC and the use of extended recovery periods, preliminary NRRA calculations show that tipping fees (what a city must pay to dispose of its trash) will increase dramatically. For example, the tipping fee for the proposed waste-to-energy facility in Detroit would rise from $12.03 to $21.25 per ton—an increase of 77 percent. The size of Detroit's bond issue would increase 35 percent. Calculations we have done for other cities show essentially the same result, and the same principles would apply to district heating and cooling.

Mr. Chairman, this magnitude of unprecedented cost increases will halt many projects and will contribute to the further deterioration of urban infrastructure. In Detroit's case, over 5 years of development effort and associated costs will be lost, not to mention the many jobs, directly or indirectly, created by such a major project. Many municipalities will be forced to continue to dump their trash at overcrowded and polluting landfills. In other cases, cities will be forced to relinquish all contractual control over the operation and services provided by these facilities, undermining their ability to ensure adequate garbage disposal services. We believe that the sponsors of H.R. 3110 do not intend this major redirection of national policy on resource recovery to occur.

In summary, this legislation will:

(1) Halt or undermine many resource recovery projects.

(2) Add uncertainty to the tax code that will weaken the public sector's ability to negotiate fair contracts with the private sector.

(3) Increase development and legal costs that already are staggering for local governments.

(4) Shift national policy to discourage resource recovery development and the private sector's traditional role in public projects.

Mr. Chairman, we thank you for the opportunity to testify. It is essential that waste-to-energy, district heating and cooling and other worthwhile public purpose projects be protected from the potential crippling effect of this bill.

Chairman **Rostenkowski**. Mr. Hendrickson, you may proceed.

STATEMENT OF BRUCE HENDRICKSON, VICE PRESIDENT, ENGINEERING SERVICES, BROWNING-FERRIS INDUSTRIES, INC., ON BEHALF OF THE INSTITUTE OF RESOURCE RECOVERY, NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION

Mr. **Hendrickson**. Thank you, Mr. Chairman.

I am Bruce Hendrickson. I am vice president of Browning-Ferris Industries, Inc., from Houston, Tex. I am speaking today on behalf of the National Solid Wastes Management Association's Institute of Resource Recovery. The institute is made up of the vendors of waste-to-energy resource recovery systems in North America.

Using various modern technologies, these resource recovery systems provide for the disposal of large masses of municipal solid waste together with the recovery of energy in the form of steam and electricity and of metals. Approximately 20 major resource recovery systems are already in operation or under construction. I am also aware of over 100 communities who are developing plans for such systems.

The institute and all members of the resource recovery industry are vitally concerned about the potential negative impacts of H.R. 3110.

Our objective today is to insure that the committee understands clearly the material adverse implications for addressing solid waste disposal problems which would be caused by the legislation. These implications were, we very much hope, unintended by the sponsors of the bill, but they are nonetheless very real. Its adoption would hamstring the timely development of waste-to-energy plants just as that process is finally gaining momentum.

In the 1970's the Federal Government and the Congress recognized the national scope of solid waste disposal problems and additionally recognized the contribution that burning solid wastes could make in offsetting fossil fuel usage.

Congress has encouraged local communities developing energy-producing garbage disposal facilities by providing tax incentives to reduce costs to dispose of municipal wastes. H.R. 3110's proposal will increase disposal fees and will delay procurement of waste-to-energy facilities by reducing financing alternatives available to communities. Eventually, the community will probably purchase these facilities, but the delay will be costly.

Federal initiatives, followed in many instances by parallel State initiatives, actually took two forms with respect to financing projects. The first was project-specific assistance.

The second Federal program was tax incentives to encourage private sector partners for cities pursuing resource recovery projects. We have supported this type of relatively neutral stimulus because it encourages all projects equally. It places all vendors on the same footing when competing for a project and at the same time allows certain tax benefits to be passed on to investors who provide the funds.

Local communities are then able to benefit through lowered disposal costs. Equally important, because tax programs have been relatively slow to change, when compared to grant and loan guarantee programs, private companies and communities were able to make long-range plans for project financing.

H.R. 3110, however, would restrict these tax incentive programs, introducing uncertainty with respect to financing alternatives. This disruption will cause delays in project implementation which can be translated into greater cost to the citizens and delay in implementing environmental standards.

Communities depend on active participation of waste disposal companies to make resource recovery projects become a reality. There are very few municipalities able to build a facility without an equity partnership with the private sector. Private sector facility vendors are presently involved not only in the capitalization but in the technological and operational areas of waste facility development. These are areas of involvement in which many local governments are not well versed, and in which they are usually unwilling to absorb large amounts of financial and operating risk.

Cities have learned that in most resource recovery projects, the economics are very marginal, especially in the early years of the project. In order for local officials and the taxpayers to make the decision to develop what may be the largest single capital investment for the community, disposal charges, tipping fees, must be reasonable and competitive with other disposal options.

Therefore, private sector companies investing in the facilities cannot expect tipping fees to be adjusted enough to provide the necessary return on investment.

Should economic benefits of the existing tax system be eliminated, it is simply unrealistic to assume that local governments can replace them through operating subsidies or dramatically increased waste disposal fees. Removal of the Federal tax incentives would undermine congressional policy to promote resource recovery and leave these cities without hope of implementing the resource recovery goals set for them by Congress.

The suggestion that certain service contracts may be treated as leases would strike to the heart of the resource recovery industry.

H.R. 3110 is unclear in the definition of a service contract. The Institute of Resource Recovery has successfully convinced a number of State legislatures to change their laws to remit full service contracting for long periods of time for the construction and operation of waste-to-energy facilities.

Clearly, the adverse impact of the proposed rules under H.R. 3110 must be viewed in the context of the desirability of these resource recovery facilities. The membership of the NSWMA feels that the facilities hold out great promise and represent a progressive trend. The Federal Government has clear policy encouraging resource recovery facilities and has encouraged the municipalities of the country in their pursuit of resource recovery facilities.

The basic issue was addressed by Congress as recently as last year in the course of its deliberations on industrial development bonds. Congress decided then that solid waste recovery projects were of particular merit.

On behalf of the NSWMA, I want to thank the committee for the opportunity to present this statement. We would like the opportunity to submit further information on the effects that H.R. 3110 would have on community tipping fees if and when a computer analysis is complete.

I would be pleased to answer any questions that the members may have.

[The prepared statement follows:]

Statement of Bruce Hendrickson, Vice President, Engineering Services, Browning-Ferris Industries, Inc., on Behalf of The Institute of Resource Recovery, National Solid Wastes Management Association

Good morning Mr. Chairman, and members of the Committee. My name is Bruce Hendrickson, Vice President of Browning-Ferris Industries, Inc., Houston, Texas. I am speaking today on behalf of the National Solid Wastes Management Association's Institute of Resource Recovery. The Institute is made up of the vendors of waste-to-energy resource recovery systems in North America. Using various modern technologies, these resource recovery systems provide for the disposal of large masses of municipal solid waste together with the recovery of energy in the form of steam and electricity and of metals. Approximately 20 major resource recovery systems are already in operation or under contruction. I am also aware of over 100 communities who are developing plans for such systems.

The Institute, and all members of the resource recovery industry, are vitally concerned about the potential negative impacts of HR 3110. We recognize your concerns with some types of financing transactions in which government entities or other non-taxable entities are the lessees of public facilities and federal income tax benefits attributable to these facilities accrue to private sector lessors.

Our objective today is to insure that the Committee understands clearly the material adverse implications for addressing solid waste disposal problems which would be caused by the legislation. These implications were, we very much hope, unintended by the sponsors of the bill but they are nonethless very real. Its adoption would hamstring the timely development of waste-to-energy plants just as that process is finally gaining momentum.

Waste disposal is being regulated stringently and appropriately by federal and state government to ensure that disposal of solid and hazardous wastes is accomplished in an environmentally safe manner. Owing largely to these regulations, the country is also moving toward energy recovery type waste disposal plants in keeping with the Congressional mandate to increase energy independence.

In the 1970's the federal government and the Congress recognized the national scope of solid waste disposal problems, and additionally recognized the contribution that burning solid wastes could make in offsetting fossil fuel usage. The Resource Conservation and Recovery Act of 1976 (RCRA) listed specific goals for solid waste disposal and recovery of usable energy and materials. The Energy Security Act of 1978 further recognized the energy contribution of this industry. These two acts represent a mandate by Congress to dispose of solid waste in an environmentally sound manner and to encourage the development of energy recovery from solid waste.

Congress has encouraged local communities developing energy-producing garbage disposal facilities by providing tax incentives to reduce costs to dispose of municipal wastes. HR 3110's proposal will increase disposal fees and will delay procurement of waste-to-energy facilities by reducing financing alternatives available to communities. Eventually, the community will probably purchase these facilities, but the delay will be costly.

Federal initiatives, followed in many instances by parallel state initiatives, actually took two forms with respect to financing projects. The first was project-specific assistance such as study grants, construction grants and loans for unique processes, R&D loans, loan guarantees, price support loans and entitlements. NSWMA opposed these financing programs vigorously because they tended to pit "grantsmen" against legitimate private-sector corporations who have the technical and financial basis to complete a project and make it work. Further, communites tended to line up hoping for federal funds. They delayed solving their solid waste problems. I am glad to see that none of these programs are currently being funded by the Administration or Congress.

The second federal program was tax incentives to encourage private sector partners for cities pursuing resource recovery projects. We have supported this type of relatively neutral stimulus because it encourages all projects equally. It places all vendors on the same footing when competing for a project and at the same time allows certain tax benefits to be passed on to investors who provide the funds. Local communities are then able to benefit through lowered disposal costs. Equally important, because tax programs have been relatively slow to change, when compared to grant and loan guarantee programs, private companies and communities were able to make long-range plans for project financing. HR 3110, however, would restrict these tax incentive programs introducing uncertainty with respect to financing alternatives. This disruption will cause delays in project implementation which can be translated into greater cost to the citizens and delay in implementing environmental standards.

Communities depend on active participation of waste disposal companies to make resource recovery projects become a reality. There are very few municipalities able to build a facility without partnership with the private sector. Private sector facility vendors are presently involved not only in the capitalization but in the technological and operational areas of waste facility development. These are areas of involvement in which many local governments are not well versed, and in which they are usually unwilling to absorb large amounts of financial risk.

Cities have learned that in most resource recovery projects, the economics are very marginal, especially in the early years of the project. In order for local officials and the taxpayers to make the decision to develop what may be the largest single capital project for the community, disposal charges (tipping fees) must be reasonable and competitive with other disposal options. Therefore, if available tax incentives are removed, private sector companies investing in the facilities cannot expect tipping fees to be adjusted enough to provide the necessary return on investment. Local governments can and do subsidize resource recovery to some extent. However, there is a definite limit on the ability of local communities to themselves supply larger subsidies. Their capacity is limited under the best of circumstances and we all know that the last few years have been far from good for the financial condition of most local governments. Should economic benefits of the existing tax system be eliminated, it is simply unrealistic to assume that local governments can replace them through operating subsidies or dramatically increased waste disposal fees. Removal of the federal tax "subsidy" would undermine Congressional policy to promote resource recovery and leave these cities without hope of implementing the resource recovery goals set for them by Congress.

If elimination of the tax incentive discourages private equity investment, the increased amount of debt and corresponding debt service to be carried by the municipal sponsor of the project would probably destroy the economics of most projects.

The economic implications of eliminating existing tax benefits are thus straightforward and dramatic—higher waste disposal charges to the municipal government contracting for the services of the disposal facility. The increased project carrying costs, arising from the vendor's displaced equity, translate directly into higher contract charges. These charges might, indeed, prove prohibitive and cause the termination of the proposed project itself. The municipality is, thus, foreclosed from utilizing waste disposal technology that the federal government has attempted to nourish and foster.

The suggestion that certain service contracts may be treated as leases would strike to the heart of the resource recovery industry. HR 3110 is unclear in the definition of a service contract. The Insitute of Resource Recovery has successfully convinced a number of state legislatures to change their laws to permit full service contracting for long periods of time for the construction and operation of waste-to-energy facilities.

Thus most projects today feature a negotiated contract which protects both the public and private sector parties involved. This contract provides for the contractor to build and operate the facility for periods up to 20 years. It is a guarantee to the community that their facility will dispose of municipal solid waste in an environmentally acceptable manner. HR 3110 could eliminate this practice.

The Committee should understand that these few municipally-sponsored resource recovery systems are truly privately-owned projects characterized by their unique role of providing an essential public service. They are not public facilities "being put up for nominal private ownership while still being used as public facilities." The private sector owners of these facilities provide a service which would otherwise be required by the municipality directly, but they accept very substantial risks of loss during all phases of development, construction and operation while retaining meaningful potential for profit. To be sure, the municipality shoulders certain risks to entice the private entrepreneur to build the facility, but on balance, substantial indicia of ownership remains in the private sector owner. Moreover, after some period of time, (generally less than 80 percent of the useful life of the facility), the waste disposal service contracts between the facility owner and the municipality terminate and the facilities revert to private use as well as ownership. This reversion to private use as well as ownership is not economically meaningless. These facilities are not inherently public and without genuine value to the private sector owners.

Clearly, the adverse impact of the proposed rules under HR 3110 must be viewed in the context of the desirability of these resource recovery facilities. The membership of the NSWMA feels that the facilities hold out great promise and represent a progressive trend. The federal government has clear policy encouraging resource recovery facilities and has encouraged the municipalities of the country in their pursuit of resource recovery facilities. This basic issue was addressed by Congress as recently as last year in the course of its deliberations in TEFRA on industrial development bonds. Congress decided then that solid waste recovery projects were of particular merit.

I would like to point out that typically, it will take 3–4 years to build and place into operation a waste-to-energy facility. The construction contractor will employ up to 200 workers during this period. When completed, the facility will employ 60–75 full-time staff. It will commence returning taxes to the treasury as soon as construction begins.

We believe elimination of existing tax incentives would be a severe setback for municipalities attempting to make environmentally desirable choices about waste disposal, and in effect would be a de facto mandate by Congress for long term reliance on landfills, an exact reversal of our present policy.

On behalf of the NSWMA, I want to thank the Committee for the opportunity to present this statement. We would like the opportunity to submit further information on the effects that HR 3110 would have on community tipping fees if and when a computer analysis is complete.

I would be pleased to answer any questions that the members may have.

Mr. PICKLE. We thank all you gentlemen for your testimony. I have a question I want to ask Mr. Oosterhuis. If you think that the provisions of the bill are unfair to short-life properties and you think that the extended life we have given it is not fair because it is twice as long, what do you recommend that we use? What approach do we take?

Mr. OOSTERHUIS. Well, it is our view that there is no reason to change the life at all. All you need to do is limit the application of the provisions in the bill to equipment that has a longer life than 5 years if it is 5-year ACRS equipment and equipment that has a life longer than 3 years if it is 3-year ACRS equipment.

With respect to computers, as I mentioned, the combined ACRS life and the depreciation rate under it is slightly slower than was the permitted ADR life adrate that most companies used, so there is really no reason to change it whatsoever.

Mr. **Pickle**. In the extended life, would we use the old ADR life?

Mr. **Oosterhuis**. If you allow the company to use any of the choices permitted under ADR, that would be all right. If you required use of ADR midpoint life, which for computers would be 6 years, and then required straightline depreciation, we would object. That would slow down our depreciation significantly. We think it brings our depreciation down for a level less generous than economic depreciation, being that no abuse exist in the first place, why do it. In addition, from a practical point of view, the problem is that with any new depreciation rules companies would have to have three lease rates. Computer companies have a sales force nationwide. Sometimes the salesmen go and sell to tax-exempt institutions and sometimes they go and sell to regular businesses. Today all these salesmen have essentially two lease rates. They have one lease rate where the investment credit is being passed through to the lessee. The second rate where the investment credit is being retained by the company manufacturing the equipment. Tax-exempt institutions take the same lease rate as do taxable institutions where there is no investment credit retained by the lessor. If you change the depreciation rules even slightly, you have to set up a third set of lease schedules to deal solely with tax-exempt institutions and, quite frankly, it would complicate the lives of people in the companies considerably without accomplishing any goal that you really need to accomplish.

Mr. **Conable**. Is it your position that this compounds, then, the problems under ACRS?

Mr. **Oosterhuis**. Absolutely.

Mr. **Conable**. Basically, ACRS has been unfair to the very short-term period obsolescent equipment, has it not?

Mr. **Oosterhuis**. That is right. Even when the investment credit was involved, ACRS was a step backward rather than a step forward for companies manufacturing computers and similar products. When you take situations like leases to tax-exempt institutions where there is no investment credit at all, then clearly ACRS was a step backward rather than a step forward. As a consequence, to further limit depreciation from that point does not seem to us to make any sense. Moreover, you don't need to do that to accomplish the kinds of policy goals that you intend to accomplish.

Mr. **Pickle**. We had hoped when we introduced the bill that it would take care of the short-term leasing provisions. We exempted this specifically, we really had in mind the 60-, 90-, 120-day period, but now we are finding, of course, that these longer term, short lifes go past that date, 2 years, 3 years, and whereas we extended it on the broad base to 12 years, I think we recognize the fact that in some cases the life of that particular equipment is much less than that, 5 years or even 3 years.

Mr. **Oosterhuis**. That is right.

Mr. **Pickle**. So I think you make a point. I don't know how we will handle this, but I recognize that there is a difference.

Mr. Hendrickson, if you build a solid waste plant in Houston, Tex., and you get the private sector involved, and you operate that plant for the city, will they be city employees or will they be your employees?

Mr. HENDRICKSON. They would be our employees operating the plant, private industry's employees.

Mr. PICKLE. Well, today city employees operate these disposal plants. We have millions of Americans who are city employees. They will now become your employees.

Mr. HENDRICKSON. Yes, sir, the most recent plants financed in the resource recovery business, I think, 4 out of 5 are being operated by private companies with private employees.

Mr. PICKLE. We might have a lot less city, county, governmental employees. Is that good?

Mr. HENDRICKSON. Yes, sir, from our standpoint it is.

Mr. PICKLE. There could be a difference of opinion there, I am sure.

Thank you. Mr. Chairman.

Chairman ROSTENKOWSKI. Are there any further questions?

Mr. GUARINI. Yes; Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. Mr. Zimmerman, if this bill goes through, then I understand that proprietary hospitals and public hospitals would be on two different footings, is that right?

Mr. ZIMMERMAN. That is right.

Mr. GUARINI. Today they are on the same footing?

Mr. ZIMMERMAN. Today they are on the same footing because 5-year ACRS apply to both, except for the investment credit. The investment credit obviously does exist in the case of proprietary hospitals, but is not applicable to the not-for-profit hospitals.

Mr. GUARINI. So it would give proprietary hospitals an edge?

Mr. ZIMMERMAN. Yes, sir.

Mr. GUARINI. So we are going on two tracks depending on whether it is a public hospital or proprietary hospital. We are really giving the edge to proprietary hospitals?

Mr. ZIMMERMAN. It would be a double edge to proprietary hospitals because the not-for-profit sector of the health care environment, which is about 85 percent of all hospitals today, has only 5-year ACRS's.

It has no investment tax.

Mr. GUARINI. Does it seem fair and logical to you that this should be a double track since we are talking about health care?

Mr. ZIMMERMAN. I believe it seems illogical to a good deal of the market, as well. As I mentioned a bit earlier, there is an unmistakable trend today toward not-for-profit institutions setting up holding companies with for-profit subsidiaries with which they are putting equipment and running pretty much at arm's length.

Mr. GUARINI. Would it be logical to have a public policy that excludes transportation but not exclude health care which is, of course, another important segment in industry and our society?

Mr. ZIMMERMAN. I cannot see the logic of treating them differently.

Mr. GUARINI. There is an inconsistency, isn't there? Let me ask you, what ratio do you have with your investors who invest in hospital leasing?

Mr. **Zimmerman**. When you say "ratio," what are you referring to?

Mr. **Guarini**. The return they get for the capital that they put in, 3 to 1, 2 to 1, 1½ to 1?

Mr. **Zimmerman**. I think most investors tend to look at this type of equipment as they would with most types of investments which would be in today's market, something which would exceed the return that they would get with lower risk investment.

Mr. **Guarini**. Do you shelter your own earnings when you make money in your leasing corporation, that is, put it back into the leasing so you can pyramid your own money shelterwise?

Mr. **Zimmerman**. We are entitled to take in the not-for-profit area, with not-for-profit hospitals we are entitled to take ACRS depreciation, and so that accounts in part as a shelter.

Mr. **Guarini**. So you do shelter part of the money that you earn?

Mr. **Zimmerman**. It is reinvested in the business traditionally.

Mr. **Guarini**. Let me ask about solid waste. Would there be capital available for many of these projects if it were not for the fact that they had these advantages in the tax laws?

Mr. **Hendrickson**. Our opinion is that there would not be. We have looked at many projects and other companies in the business, and all of them are depending heavily on the tax incentives and accelerated depreciation to make the investment in the plant.

Mr. **Guarini**. Do you see any logic in excluding transportation and not having provisions for solid waste disposal and recycling?

Mr. **Hendrickson**. I can't really speak to the difference in the two. The logic of it is that I think in this case there has been almost a Federal mandate to recover energy and materials and get rid of waste in other ways besides landfilling and this gives you an opportunity to do that.

Mr. **Guarini**. So any other result would be inconsistent as a matter of public policy to favor transportation and not take such an important subject like solid waste and give it an advantage.

Then it is your opinion that many of these plants would not exist were it not for some financial advantage that could be exercised to make it come in to fruition?

Mr. **Hendrickson**. Yes, sir, that is true.

Mr. **Guarini**. Thank you very much.

Mr. **Pickle**. Would the gentleman yield?

To the extent that we have exempted mass transit, I think consistent with the position we took in the TEFRA bill last year that granted the exemption in mass transit recovery, now there is an exception for that and if we were to add the other type of project that the gentleman wants, we could add 20, 30, 50 more of them and I am sure you would not want to make it too broad because then you would hurt yourself.

If you want to be consistent, I guess one thing you could do would be just to remove mass transit from this. Would the gentleman recommend we remove it from mass transit?

Why would you be against mass transit being exempt?

Mr. **Guarini**. I think we should be consistent. I think we should add those that have a high public priority so we can get the job done. I think it is inconsistent to give an advantage to one industry which to me would only prove that they have a better lobby in Washington going for them.

Mr. CONABLE. Would you please define those that have a high public priority for us?

Mr. GUARINI. I think recycling and waste management have a high public priority. I think health care is one of the greatest national needs we have, too, along with transportation, so why include one and exclude the others?

Mr. PICKLE. Well, we can't get them all. So if we can't do that, then if you want to be consistent, then we would remove mass transit and you are, in effect, recommending that we do away with the exemption for mass transit.

Mr. GUARINI. I am saying why be half pregnant. It is not logical and it is not consistent.

Chairman ROSTENKOWSKI. If there are no further questions, thank you very much.

The Chair calls Mr. Albrecht, Mr. Hooker, Mr. Baron, and Mr. Scheibel.

Mr. Albrecht, if you are ready, the committee is prepared to receive your testimony. You may proceed.

STATEMENT OF RICHARD R. ALBRECHT, VICE PRESIDENT AND GENERAL MANAGER, EVERETT DIVISION, BOEING COMMERCIAL AIRPLANE CO.

Mr. ALBRECHT. I am Richard R. Albrecht, vice president, general manager, of the Everett Division of the Boeing Commercial Airplane Co. with responsibility for the 747 and 767 programs.

I would like to emphasize at the outset that the provisions of H.R. 3110 as proposed would not directly affect Boeing or any of its own planned financing.

Rather, I am here to highlight for the committee the adverse effects that certain provisions of H.R. 3110, as presently proposed, would have on our non-U.S. airline customers who have committeed to purchase, or desire to purchase, new Boeing 747 airplanes.

In addition, I would like to outline the potential for harmful, longer term effects in terms of American jobs.

By way of background, it is important to realize that the majority of our 747's are sold to foreign airlines. Between 1969 and 1982, 71 percent of the 747's ordered were exported.

We estimate that beginning this year, 81 percent of the total 747 production will be sold to non-U.S. customers. As with most commercial aircraft, our 747 customers rely heavily on access to the U.S. capital markets for financing of their aircraft.

Both the availability and terms of financing depend considerably on the tax effects of those providing the capital.

As of today, we have 15 new 747's under firm contracts with six non-U.S. airlines, each of whom are at various stages of arranging leverage-lease financing with U.S. leasing companies.

These 15 aircraft are scheduled for delivery over the next 2 to 3 years, beginning this month.

The Boeing Co. is in full sympathy with what we understand are the main objectives of H.R. 3110. However, passage of H.R. 3110 in its present form would prevent the above six Boeing customers, as well as all future non-U.S. 747 purchasers, from utilizing tax-leveraged financing to purchase new capital equipment.

We believe that with respect to airplanes, particularly the Boeing 747, the restrictions in the present law go far enough. The investment tax credit and the accelerated cost recovery system benefits were designed to encourage investment in new capital equipment.

They have never been available to a non-U.S. airline unless the requirements of section 48 of the Internal Revenue Code are met; namely, that the airplane be registered with the Federal Aviation Administration and operated regularly to and from the United States.

These restrictions have been in effect ever since the investment tax credit was first initiated in 1962.

We submit that it is unnecessary to restrict further the ability of those non-U.S. carriers qualifying under the present law to obtain financing for new 747 airplanes in order to reach the apparently unintended effects of the recent tax legislation.

By the nature of the 747 program, long lead times are required and commitments to purchase are made by our customers from 1 to 4 years prior to expected delivery of the airplanes.

Financing commitments, on the other hand, are not generally made until shortly before delivery because of the fluctuation of market rates. We believe it would be inequitable to change the rules under which financing from the U.S. capital markets is available after a commitment to buy has been made.

In contacting Boeing regarding the effects of H.R. 3110, several of our non-U.S. 747 customers have advised that their proposed financing for currently contracted airplanes would be jeopardized by passage of H.R. 3110 in its present form.

They have also commented that elimination of tax-leveraged financing would adversely effect the number of new 747 airplanes which may be ordered in the future.

It follows that loss of 747 sales will result in eventual loss of American jobs. A 1982 study by the Aerospace Industries Association concluded that in the commercial airplane industry, there are 13,400 direct jobs and 31,575 indirect jobs, a total of 44,975 jobs, dependent on each $1 billion in sales.

At a sales price ranging up to $100 million each, few sales can be lost before there is a dramatic effect on employment, not only at Boeing, but at the thousands of suppliers throughout the United States who benefit from 747 sales.

The fact that our 747 customers are raising the possibility of reducing the number of airplanes to be ordered in the future should be a concern to all of us in terms of unemployment.

This leads me to a related point. Today Boeing must compete in the international market against a foreign competitor which receives direct and indirect government subsidies.

World-wide political influence on behalf of this foreign competition is also in evidence. In the case of the 747, the situation is even more difficult.

Current discretionary policies of the Export-Import Bank disqualify the 747 from export financing, which makes our ability to market the 747 internationally that much tougher. To eliminate the ability of our foreign airline customers to finance 747's through leverage leasing when Ex-Im financing is unavailable to them would further handicap Boeing's ability to compete effectively.

Again, American jobs depend on our ability to continue to sell 747's and to have them financed on the same basis available since 1962.

I urge the committee to amend H.R. 3110 to preserve tax-leveraged financing for those non-U.S. airlines who presently qualify in recognition of the fact that in the long run 747 sales sustain U.S. employment and benefit our economy as a whole.

Chairman ROSTENKOWSKI. Mr. Hooker, you may proceed.

STATEMENT OF MICHAEL K. HOOKER, PRESIDENT, BENNINGTON COLLEGE, BENNINGTON, VT.

Mr. HOOKER. My name is Michael Hooker and I am president of Bennington College.

Mr. Chairman, and members of the committee, H.R. 3110 addresses the problem of off-budget financing and to that extent I am fully supportive of its intent. However, in my judgment, the greater public good would be served by excluding higher education from the effect of the bill.

Higher education is in financial difficulty, and those difficulties are going to become far more severe in the near future. Colleges are faced with a 20-percent decline in enrollment in the next decade and proportionately lower tuition revenues.

It is not possible to respond simply by cutting costs. During the decade of the sixties, when the "baby boom" cohort was passing through college, higher education responded to the enormously increased demand on its services by expanding its facilities and faculties.

That expansion, which was done partly in response to public pressure and to pressure from Congress, resulted in certain fixed costs, which remain even in these times of decreasing enrollment and escalating costs.

Colleges are scrambling to meet costs, and my college, Bennington, serves as emblematic of the difficulties they face. In order to fund escalating operating deficits, Bennington for the last 9 months has been structuring a lease-leaseback transaction which would enable it to pay off short-term, high interest debt and to realize operating capital over the next 5 years.

I understand that a number of other higher education institutions are considering doing the same thing.

It is important in considering H.R. 3110 to recognize a difference between colleges on the one hand and governmental agencies on the other. The Internal Revenue Code has, since 1917, been constructed so as to support higher education.

That support comes through charitable contribution deductions, and more recently through the use of tax-exempt bond financing of college construction and student financial aid.

From a fundamental philosophical point of view, that of serving the public good represented by higher education through the use of tax law, I see no difference between the use of sale-leaseback financing and charitable giving.

If, however, there is in the view of the committee a substantial difference where I see none, then at least those business transactions available to private enterprise should also be available to independent colleges and universities.

It is ironic that a college could not benefit through reduced costs by selling its building to investors and leasing it back, but any business that owned its own building could so benefit.

In neither case is the tax status of the institution relevant to the financial structure or attractiveness of the transaction.

This committee and its colleagues in Congress have periodically revised tax laws to give tax breaks to individuals in order to stimulate investment in enterprises that are deemed to be in the national interest.

Among such enterprises have been real estate development, oil and gas exploration, low-income housing, agricultural development, and a host of others.

While it was not the intent of Congress to support higher education through laws governing real estate depreciation, it is a fortuitous result of tax law that colleges can so greatly benefit without the infusion of massive Federal aid.

Whereas now tax-sheltered private investment is going to support the purchase and syndication for sale of already existing office buildings, shopping centers, and apartment complexes, it is surely in the greater national interest that our colleges remain strong.

It would be shortsighted not to look to the uses to be made of money generated through sale-leaseback transactions and to ask whether those uses are indeed in the national interest.

If the answer is yes, as it is in the case of higher education, and if Congress doesn't permit colleges the use of sale-leaseback financing, then we risk the future of this Nation by insuring that institutions of higher education will decline in quality.

Thank you very much, Mr. Chairman, for the opportunity to appear here.

Chairman ROSTENKOWSKI. Thank you, Mr. Hooker.

Mr. Baron, you may proceed.

STATEMENT OF STEVEN J. STOGEL, VICE PRESIDENT, McCORMACK, BARON & ASSOCIATES, ON BEHALF OF YWCA, JERSEY CITY, N.J.

Mr. STOGEL. I am appearing today for my partner, Mr. Baron.

Mr. Baron and I are principals in a company called McCormack Baron in St. Louis, and we are a research, development, and management consulting firm.

My partner was here earlier this morning and was called away to Cleveland to meet with some city officials there where we are working on some innercity housing.

Chairman ROSTENKOWSKI. Mr. Stogel, please identify yourself for the record.

Mr. STOGEL. My name is Steven Stogel, vice president of McCormack, Baron & Associates.

I would like to ask Martha Lewin, the executive director of the YWCA in Jersey City, N.J., to make a few remarks about a development project that her organization and ours were 50-50 partners in.

Chairman ROSTENKOWSKI. Ms. Lewin, you may proceed.

STATEMENT OF MARTHA LEWIN, EXECUTIVE DIRECTOR, YWCA, JERSEY CITY, N.J.

Ms. LEWIN. I am Martha Lewin, the executive director of the YWCA in Jersey City.

I would like to tell you a little bit about the YWCA and then ask Mr. Stogel to explain to you how we were able to accomplish what it is that we have done in Jersey City.

The YWCA is a very big building in a mixed commercial/residential downtown section of Jersey City, and it has served for over 75 years poor, needy people in the community.

The services that we provide in Jersey City in Hudson County for that matter are services that no one else has ever provided or cares to provide. By renovating our building and making it financially stable for us and for the community, we were able to continue to provide these services to the people of Jersey City and Hudsdon County.

We operate a group home for adolescent children who have no place else to go, who have run away, been thrown out, have had beginning court involvement and because they are able to come with us are then, therefore, not needed to go to institutions and perhaps we can work with them in a way to provide the kind of counseling that enables them to become productive, taxpaying citizens in our community.

We operate something we call the family advocacy program, which is an intervention program with families who have children that are already in serious trouble; where a group home situation is too late, actually, where children have been incarcerated once or twice, have been in residential treatment centers once or twice and where the family, because it has been disfunctional, needs serious, ongoing 24-hour intervention in order to get itself together and to keep its children at home.

We operate a battered women's program which is the program that most people can relate to best of all. It is a program which includes a shelter and a counseling program for women and their children who are victims of domestic violence.

It is a program that takes women and children who have been in some of the most horrible situations that any of us could ever imagine and gives them a place to live and gives them 24-hour support and counseling so that they can pull their lives together and do something creative for themselves.

I would like to have Mr. Stogel explain to you how we were able to accomplish our redevelopment project.

Mr. STOGEL. Thank you.

The building we found in New Jersey was an 11-story tower building with a 5-story annex in which Martha's organization was struggling.

Just the costs of carrying it alone were taking her organization down. We divided the building into two essential parts. The annex became 23,000 square feet of program space out of which Martha now operates and the tower became 79 units of residental housing.

The project was financed entirely through the State of New Jersey Housing Finance Agency, which financed not only the housing component but the program space component, the programs Martha outlined, as well as programs for the elderly citizens who occupy the tower.

There was a syndication involved. It was the combination of the equity syndication so that prior investors could realize the tax advantages. The section VIII program for the rental assistance to support the cost of the debt service and the long-term financing that was made possible by tax-exempt bonds that made the project possible.

Without any one of those elements, the project would not have been successful. Martha's group is typical of many nongovernmental, tax-exempt organizations that exist in the United States whose efforts are trying to stabilize their neighborhoods and provide services to those neighborhoods.

By and large these organizations previously received Federal or State assistance much of which has recently been curtailed.

Further, these organizations are generally financially strapped, if not insolvent. In addition, many of these organizations have the added burden of carrying buildings that are old and large, that housed their entire operations at some earlier time.

Over the last two or three decades, populations in these neighborhoods have declined and the organization's ability to effectively continue to utilize all the space as it had been used, that is the organization itself was capable of using it, has also dramatically declined.

It is also our experience that these neighborhoods are not gentrified and can support only modest commercial and residential rents, nevertheless, the communities and neighborhoods that comprise the better parts of our urban areas.

Gleaming, newly constructed, downtowns may anger urban revitalization, but the people live, work, and vote in these neighborhoods and communities.

The community groups may be church related, tenant management groups, neighborhood alliances, civic educational, cultural coalitions of concerned citizens.

Our firm in the last 4 years has worked with four separate neighborhood and tenant management groups in St. Louis involving 740 units of housing in four separate neighborhoods: With the Chamber of Commerce of Springfield, Ill., involved in the central cities commercial revitalization part of the 65,000 square foot commercial project in which the chamber of commerce constituted a prime tenant and with the YWCA in Jersey City involving 20,000 square feet of program space.

The cost of the credit in the New Jersey project that stemmed from the availability of tax credits resulting from a 40-year old structure which applied to the program space and not to the residental space was $600,000.

It generated a $10 million development and I submit the income that was generated from that far outweighed any burden or revenue loss to the Treasury. We were actively involved in a project in Akron, Ohio.

Mr. Fred Fuerst, executive director of the Akron YMCA is here today to address that project, but we have some specific recommendations.

To save these kinds of neighborhood services being rendered by these neighborhood groups, we would propose and request an exemption under H.R. 3110 from the depreciation investment tax limitations for nongovernmental, tax-exempt organizations which lease all or some of the space and real property whether it was ever owned or not by the exempt organization, which real property is substantially renovated involving qualified rehabilitation expenditures of at least five times the acquisition costs which excludes from basis any acquistion costs financed by purchase money indebtedness to either provide it directly or indirectly by the tax-exempt organization which real property after being placed in service and for the 5 years thereafter to tie into investment tax credit recapture period requires the tax-exempt to be provided under section 5013C of the code and there is a conjunctive test which real property is located in UDAG eligible or other target areas within our cities.

Thank you.

[The following was submitted for the record:]

McCormack, Baron & Associates
4625 Lindell Boulevard
St. Louis, Missouri 63108

314-361-4500

June 5, 1983

Honorable Dan Rostenkowski
Committee on Ways and Means
United States House of Representatives
Capital Building
Washington, DC

RE: H.R. Bill No. 3110

Dear Mr. Chairman:

It is assumed that this proposed legislation, particularly Part B on denying the investment tax credit where tax-exempt financing is used, is intended to be limited to tax-exempt (as opposed to taxable) lessees. If this assumption is not correct, then the effect of this legislation would be to immediately curtail urban revitalizations. Given the high cost of construction and land costs, but the low rent levels for residential or retail space, both tax-exempt financing for lower interest rates and the tax-credit for equity participation are vital to "make the numbers work." The removal of either tax-exempt financing or tax-credits from funding sources for taxable lessees will undermine the ability to make urban residential or retail projects possible!

Assuming this legislation, in its present form is limited to tax-exempt lessees, it will substantially impede the redevelopment and revitalization of urban areas by discriminating against legitimate community-based non-governmental tax-exempt organizations.

In neighborhoods and communities all across the country, there are non-governmental tax-exempt organizations trying to stabilize their neighborhoods and to provide services to those neighborhoods. By and large, these organizations had previously received Federal or state assistance, much of which has been recently curtailed, and further, these organizations are generally financially strapped, if not insolvent.

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In addition, many of these organizations have the added burden of "carrying" old, sometime large, buildings that formally housed their former operations. However, over the last two or three decades, the population in these neighborhoods have declined, and the organization's ability to effectively continue to utilize all the space as it had been used (and as the organization itself was capable of using it) also dramatically declined.

It is also our experience that these neighborhoods are ones not "gentrified," and can support only modest commercial or residential rents, but nevertheless, are the neighborhoods and communities that comprise the better parts of all our urban areas. Gleaming newly constructed "downtowns" may anchor urban revitalization, but the people live and work and vote in these neighborhoods and communities.

The community groups may be church-related, tenant management groups, neighborhood alliances, civic-educational-cultural affiliations, or other coalitions of concerned citizens.

Our firm has in the last four years worked with four separate neighborhood and tenant management groups in St. Louis involving 740 units of housing in four neighborhoods; with the Chamber of Commerce of Springfield, Illinois involving the central city's commercial revitalization of part of a 65,000 square foot commercial project of which the Chamber constituted a prime tenant; and with the YWCA in Jersey City, New Jersey involving 23,000 square feet of program space for the YWCA and 79 elderly residential units.

The Jersey City experience is a good example of the adverse effects of legislation. The Jersey City YWCA (which like all other YWCAs receives no assistance from the national organization) was "trapped" by an 80,000 square foot building - the YWCA in 1980 only utilized 10-15,000 square feet. The balance of the space (formerly a lodging facility) remained unused, and constituted a financial drain on the YWCA's limited resources. In 1981, the YWCA sold the entire building to a limited partnership for its fair market value, and the YWCA agreed to lease back 24,000 square feet (or 30%) of the building for program space for its social services for the Jersey City community, including after school and summer programs for adolescents; group home for boys and girls who "run-away" from home; a family advocacy program for troubled youths in lieu of institutionalization; and a battered women's shelter. The remainder of the building was rehabilitated into 79 units of housing. In all, it was a $10,000,000

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development project involving The Jersey City YWCA, the State of New Jersey's Housing Finance Agency, the City of Jersey City, The Ford Foundation, a Wall Street banking firm, and our firm. In fact, this project was commended in the 1982 Presidential Commission on public-private partnerships. And most important, the building is completed; the YWCA is no longer burdened by the building; and is providing full-fledged and expanded community services; and that neighborhood's most visible liability has turned into that neighborhood's most visible asset.

But, if the proposed legislation were then on the books, the project would not have been possible. The tax credits available on the YWCA's program space made the sole difference in the project's ability to finance the transaction.

And this is again true of our activities both in Jersey City (again in connection with the YWCA) of the recycling of a local neighborhood vacant school building for further activities of the YWCA, as well as the proposed development in Akron, Ohio with the Akron YMCA. The scope of the Akron project deserves elaboration only to demonstrate the non-uniqueness of the New Jersey project. In Akron, the YMCA and our firm intends to convert a long vacant 90,000 square foot historic property into 49 apartment units, 9,000 square feet of general commercial space and 20,000 square feet of program space for the YMCA. The Akron YWCA had previously used this downtown facility as its headquarters, and wishes to return to the downtown from its suburban location. This project would bring that resource back to Akron's downtown.

Joining our firm at the hearing on June 8, 1983 will be Ms. Martha Lewin, the Executive Director of The Jersey City YWCA, and Mr. Fred Fuerst, Executive Director of the Akron YMCA, to help explain the adverse impact of HR 3110 as currently proposed.

It is respectfully requested that an exemption be included in HR 3110 to allow for the continued redevelopment and revitalization of urban communities and neighborhoods utilizing the efforts, enthusiasm, commitment and even limited resources of non-governmental tax-exempt organizations, such as neighborhood, community, tenant, civic, cultural or educational groups.

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The specific request is to exempt from the depreciation and investment tax credit limitations now proposed in HR 3110:

(i) non-governmental tax-exempt organizations;
(ii) which lease all or some space in real property (whether or not ever owned by the exempt entity);
(iii) which real property is substantially renovated, involving qualified rehabilitation expenditure of at least five times the acquisition cost;
(iv) which excludes from basis any acquisition costs financed by purchase money indebtedness provided directly or indirectly by the tax-exempt organization;
(v) which the real property after being placed in service and for the five years thereafter (to tie into the investment credit recapture period) requires the tax-exempt lessee to provide housing or other permitted activities under Section 501(c)(3); and
(vi) which real property is located in UDAG eligible or targeted areas.

Respectfully submitted,

McCORMACK, BARON & ASSOCIATES, INC.

By: RD Baron
Richard D. Baron

By: Steven J Stogel
Steven J. Stogel

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Mr. **Pickle**. Thank you, Mr. Stogel.

Does that complete all the witnesses?

Do we have another one of the New Jersey group?

STATEMENT OF FRED FUERST, EXECUTIVE DIRECTOR, YMCA, AKRON, OHIO

Mr. **Fuerst**. No. I am from Akron, Ohio. My name is Fred Fuerst, executive director of the Akron YMCA.

Mr. **Pickle**. All right, Mr. Fuerst. Not that the other would not have been all right, too. I am trying to see the volume.

Mr. **Fuerst**. My volume will be short and to the point. It will be primarily good news and bad news.

Mr. **Pickle**. We are glad to have you.

Mr. **Fuerst**. The Akron YMCA is the owner of a seven-story building in downtown Akron. It is a 53-year old building currently on the Historical Register.

The bad news is that the building has been vacated for 30 months. For the past 9 months, we have been working with McCormack and Baron, the developers on the rehabilitation of our building.

A portion of that building will be renovated for the YMCA for its inner-city programs. We are approximately 3 months from construction.

The passage of H.R. 3110 in its present form would cause the project to come to a halt and because of that for the Y to seriously have to consider, due to the financial burden of a vacant building, of walking away from the building.

The ability to move ahead under the current law or some kind of revision would mean the following: Return of needed human services to the center of our city; tax revenue of $50,000 a year to the city of Akron currently not received because that building is tax exempt; a major setup in the downtown redevelopment plan of Akron, Ohio.

The community has agreed to raise approximately a million and a half dollars in private funds to rehab the Y portion. With the Federal cutbacks in social programs, the burden has shifted to the private sector whose arm is the private, nonprofit organizations such as the YMCA.

We need the collaboration of the Federal Government, the local government and private and nonprofit to deliver the needed human services in our major cities.

Thank you.

Chairman **Rostenkowski**. Mr. Scheibel you may proceed.

STATEMENT OF JAMES SCHEIBEL, CITY COUNCILMAN AND MEMBER, ST. PAUL CIVIC CENTER AUTHORITY BOARD, ST. PAUL, MINN.

Mr. **Scheibel**. Mr. Chairman, and members of the committee, thank you for the opportunity to address you today.

I am Jim Scheibel, chairman of the finance committee of the St. Paul, Minn., City Council and a member of the Civic Center Authority.

As I am sure you are aware, the city of St. Paul is extremely concerned about the impact of the bill recently introduced by Representative Pickle concerning lease financing by municipalities and other public agencies.

I want to make clear at the outset that our concern is not with the basic legislation, but with provisions which we feel will be seriously damaging to four very important projects in progress in the city. My purpose this morning is to ask you to address those provisions immediately.

For a number of years, the city of St. Paul has endeavored to find the financial resources to remodel its older municipal auditorium, originally constructed in 1932. We are in need of a renovated convention center.

At the same time, we need immediate structural improvements to the parking facility which has experienced severe deterioration due to salt intrusion in the concrete. The combination of these two projects total $10 million of very necessary repairs.

We retained financial and legal experts last July to assist in structuring financing which we could afford. The plan, which was approved in concept last September and which received formal, final authorization in April of this year, involves the sale and leaseback of our entire civic center complex to a group of private investors.

After considerable community discussion and very involved financial and legal arrangements, we were prepared to issue bonds to finance this project on June 15 of this year.

We received in mid-May of this year a formal pledge of bond insurance which provides the security necessary to sell the bonds. All of the legal documents are now drafted and a preliminary, official statement has been released.

All of these efforts were done in good faith and with no information that the entire method we were relying on to complete this important project during this construction season was going to be placed in doubt by H.R. 3110.

It is critical that this important construction project proceed this summer. Thus, we are requesting immediate action by Congress to provide for transition language necessary so that the important deliberations of this committee on the issue surrounding H.R. 3110 can proceed without impeding our ability to complete work that has been over 12 months in the planning and which has cost, to date, in excess of $300,000.

I would add that the civic center project has already begun construction on a first phase of the parking ramp improvements. We could not delay any further on this particular portion of the project, and we have only temporary financing in anticipation of securing the final bond financing from the sale-leaseback.

To summarize, construction is underway, final approval from the City Council was issued in mid-April, and bonds were scheduled to be sold June 15.

We are requesting immediate release from the language presently existing in H.R. 3110 in regard to projects in process.

Also under construction is the Ordway Music Theater, a 1,800 seat music hall which will house our St. Paul Chamber Orchestra and the Minnesota Opera Co.

In excess of $21 million has been privately raised, to date, to support this important project. An additional $17 million is necessary to complete the project and to provide for an operating endowment.

Since last summer the board of the Ordway Theater has contemplated the sale and leaseback of the facility in order to reduce the amount of funds that would have to be raised to support the project.

The Ordway Music Theater Board approved the sale-leaseback conception January of this year and the city has indicated its approval in a number of resolutions dating back to the fall of 1982.

I have attached to this testimony a copy of a letter prepared by the Ordway Theater Board and sent to Representative William Frenzel of Minnesota. I believe it clearly outlines the status of this particular project.

Again, we are asking for immediate release from the provisions of H.R. 3110, which undercut this important project in progress.

Another provision of H.R. 3110 which I want to address is that relating to rehabilitation tax credits for projects financed with industrial development bonds.

This has a very significant impact on both our Union Depot project and our Energy Park/Bandana Square project. Both of these private developments will be financed with industrial development bonds and have included as a critical aspect of financial feasibility the availability of the rehabilitation tax credit.

The Depot project involves a major structure which has been essentially abandoned for 10 years and for which a workable rehabilitation plan seemed finally to be in place.

Both projects have been well underway for many months, proceeding from preliminary bond authorization in the fall of 1982.

I believe both projects clearly serve the public purpose intended by renovating vacant, older railroad buildings which have not contributed to the economic vitality of the city for over a decade.

As representative of a city with much at stake, I ask that the particular provisions in H.R. 3110 involving rehabilitation tax credit and industrial development bond projects be lifted immediately so that such projects can proceed.

I believe there is a strong case for Congress acting swiftly to provide the kind of transition language necessary to allow the four projects I have just described to proceed with construction this summer.

I hope you find yourself in agreement that such action would not intrude on discussion of the basic issues in the legislation, but would prevent the strangling of projects begun in good faith.

I would also welcome the opportunity to discuss these issues further with members of this committee.

Thank you.

[The prepared statement follows:]

STATEMENT OF JIM SCHEIBEL, ST. PAUL, MINN.

Mr. Chairman and members of the committee: Thank you for the opportunity to address you this morning. I am Jim Scheibel, Chairman of the Finance Committee of the St. Paul, Minnesota, City Council and a member of the Civic Center Authority. As I am sure you are aware, the City of St. Paul is extremely concerned about the impact of the bill recently introduced by Rep. Pickle concerning lease financing by municipalities and other public agencies. I want to make clear at the outset that our concern is not with the basic legislation, but with provisions which we feel will be seriously damaging to four very important projects in progress in the city. My purpose this morning is to ask you to address those provisions immediately.

1. Civic Center Auditorium and Parking Ramp Remodeling Project.—For a number of years the City of St. Paul has endeavored to find the financial resources to remodel its older municipal auditorium, originally constructed in 1932. We are in need of a renovated convention center. At the same time, we need immediate structural improvements to the parking facility which has experienced severe deterioration due to salt intrusion in the concrete. The combination of these two projects total $10 million of very necessary repairs. We retained financial and legal experts last July to assist in structuring financing which we could afford. The plan, which was approved in concept last September and which received formal, final authorization in April of this year, involves the sale and leaseback of our entire Civic Center complex to a group of private investors. After considerable community discussion and very involved financial and legal arrangements, we were prepared to issue bonds to finance this project on June 15 of this year. We received, in mid-May of this year, a formal pledge of bond insurance which provides the security necessary to sell the bonds. All of the legal documents are now drafted and a preliminary, official statement has been released.

All of these efforts were done in good faith and with no information that the entire method we were relying on to complete this important project during this construction season was going to be placed in doubt by H.R. 3110. It is critical that this important construction project proceed this summer. Thus, we are requesting immediate action by Congress to provide for transition language necessary so that the important deliberations of this committee on the issue surrounding H.R. 3110 can proceed without impeding our ability to complete work that has been over twelve months in the planning and which has cost, to date, in excess of $300,000.

I would add that the Civic Center project has already begun construction on a first phase of the parking ramp improvements. We could not delay any further on this particular portion of the project, and we have only temporary financing in anticipation of securing the final bond financing from the sale-leaseback.

To summarize, construction is underway, final approval from the City Council was issued in mid-April, and bonds were scheduled to be sold June 15. We are requesting immediate release from the punitive language presently existing in H.R. 3110 in regard to projects in process.

2. Ordway Music Project.—Also under construction is the Ordway Music Theatre, and 1,800 seat music hall which will house our St. Paul Chamber Orchestra and the Minnesota Opera Company. In excess of $21 million has been privately raised, to date, to support this important project. An additional $17 million is necessary to complete the project and to provide for an operating endowment. Since last summer the board of the Ordway Theatre has contemplated the sale and leaseback of the facility in order to reduce the amount of funds that would have to be reaised to support the project. The Ordway Music Theatre Board Approved the sale-leaseback concept in January of this year and the City has indicated its approval in a number of resolutions dating back to the Fall of 1982.

As with Civic Center Auditorium and parking ramp facility, the Ordway Music Theatre Board has expended considerable sums of money on financial analysis and legal arrangements to complete this important transaction. I have attached to this testimony a copy of a letter prepared by the Ordway Theatre Board and sent to Representative William Frenzel of Minnesota. I believe it clearly outlines the status of this particular project. Again, we are asking for immediate release from the provisions of H.R. 3110, which undercut this important project in progress.

My suggestion for transition language is that for projects which received formal authorization from the governing body of the City or from the official board of the tax-exempt entity, before May 1, 1983, and which can compete the financial arrangements necessary before August 1, 1983, and be under construction before September 1, 1983, that Congress allow such projects to proceed. I believe this approach would allow all projects that have a legitimate claim to being "in progress" to proceed without loss of the good faith and dollars already invested. This would also give the Congress a greater opportunity to act on the overall merits of this legislation and to place the kinds of limitations that I think we all agree are necessary in order that this particular form of financing is not abused.

3. The Union Depot Project.—Another provision of H.R. 3110 which I want to address is that relating to rehabilitation tax credits for projects financed with industrial development bonds. This has a very significant impact on both our Union Depot project and our Energy Part/Bandana Square project. Both of these private developments will be financed with industrial development bonds and have included as a critical aspect of financial feasibility the availability of the rehabilitation tax credit. The Depot project involves a major structure which has been essentially abandoned for ten years and for which a workable rehabilitation plan seemed finally to be in place. Both projects have been well under way for many months, proceeding from preliminary bond authorization in the Fall of 1982. Both projects have also received considerable Federal support via the Urban Development Action Grant Program. I believe both projects clearly serve the public purpose intended by renovating vacant, order railroad buildings which have not contributed to the economic vitality of the city for over a decade.

As representative of a city with much at stake, I ask that the particular provisions in H.R. 3110 involving rehabilitation tax credit and industrial development bond projects be lifted immediately so that such projects can proceed.

I believe there is a strong case for Congress acting swiftly to provide the kind of transition language necessary to allow the four projects I have just described to proceed with construction this summer. I hope you find yourself in agreement that such action would not intrude on discussion of the basic issues in the legislation, but would prevent the strangling of projects begun in good faith.

I would also welcome the opportunity to discuss these issues further with members of this Committee.

Thank you.

Mr. CONABLE. Mr. Scheibel, bond attorneys seem to be very easily chilled. You want this committee to lift the disability imposed by the filing of one bill here. Do you see any possible inconsistency for the possibility of committee action to offset the effect of the great stature that Mr. Pickle's name adds to this bill? How do we handle this, for heaven's sake?

We have to file bills to consider them. The minute we file them, bond attorneys say, oh, well, we can't pass anything any more; and then we easily spend all our time offsetting the effects of single bills filed by individual Members of Congress.

I am not downgrading Mr. Pickle at all. I happen to think he has got a pretty good bill here that should be considered. We have to deal with this subject. But I am fascinated by the dynamics of this because I don't know how we are going to do business here if the minute somebody files a bill everybody goes into a state of shock out there.

Mr. SCHEIBEL. Mr. Chairman, Mr. Conable, I would rather not add any comments on bond counsel. I think you just realize the situation we are faced with. What we are asking for is a window.

The way I understand the bill is written, the provisions would be effective dating back to May 23. And, as I tried to outline——

Mr. CONABLE. The Senate does not even know this bill exists yet.

Mr. SCHEIBEL. I believe they are going to be introducing a companion bill very soon if not today.

Mr. CONABLE. Do you think they will put in the same date?

Mr. SCHEIBEL. I wish we had——

Mr. CONABLE. On June 18, you say you are going to issue your bonds. If you put in the date of June 18, would that alleviate the situation?

Mr. SCHEIBEL. If Mr. Pickle——

Mr. CONABLE. It would not be Mr. Pickle who backed off on the date he put in his bill. I don't know how we handle this matter. Congress has to function and everybody goes into a state of shock when somebody files a bill. I am confused about that. I suppose you are, too.

Mr. SCHEIBEL. Yes, sir, Mr. Conable, in part. I just tried to outline we have four projects. If the bill would have been introduced a month later, we would be able to proceed.

Mr. CONABLE. But by then there would be 83 other projects similar to yours. As a matter of fact, they are accelerating right now.

Mr. PICKLE. 883.

Mr. SCHEIBEL. I would agree with that, Mr. Conable.

Mr. CONABLE. I understand your dilemma. I want you to understand ours. If we are ever going to create any rules in this area before everybody walks off with the store, somebody has to start something some time.

I am really in a dilemma about it, Jake. Would you like to write a letter for this fellow saying it sounds like a lovely project, and he can take that to his bond counsel?

Mr. PICKLE. Well, I met with the bond counsel earlier this afternoon, and I don't think he would think my letter would mean much.

Mr. CONABLE. But he thinks your bill means a whale of a lot. I don't know. This is going to be a problem for the Congress to deal with.

Mr. PICKLE. I know that you have a problem with transition over here. That is true of 100 other projects. You have four projects, some of them lease; some of them sale/lease. Most of them have use of IDB's in connection with it.

What is the total construction project of the four projects involved?

Mr. SCHEIBEL. I would say $350 million.

Mr. PICKLE. The civic center was $60 million-some-odd?

Mr. SCHEIBEL. It is roughly $350 million.

Mr. PICKLE. Let's say $400 million. That is a pretty good hunk of financing if you want the Federal Government to assume 40 percent of it. But I accept the fact that in good faith you think that is hurrying it.

Let me give you an example of the problems we face in line with what Mr. Conable was saying. I introduced a bill earlier on industrial bonds. I am going to make them all mad, it looks like. I thought to myself, if some of these cities are trying to sponsor projects under IDB's, we ought not to just try to whack them off if they really invested money in trying to get things passed under the laws. I set a date ahead and allowed people if they had projects in the pipeline to try to go ahead and finish them and let them have some time.

So from the time I introduced it, from about the first part of March until April 15, I allowed approximately 5 weeks. The market was flooded with FSLIC bonds. You would have thought that we had pushed a great lever and everybody shoved these projects out. They financed over $4 billion of projects in that 4 or 5 weeks' time, and a third of that was through what we call the guaranteed program; that is through FSLIC and the FDIC guarantee.

Now, that gives you the scope of the volume that is involved. Any date you take—and, as Mr. Conable said, we have to get a date—I am mindful of your problem. We did not enter into this to be punitive.

The same is true with Mr. Hooker in his situation. We feel we have an obligation toward higher education, but if we have higher education we have to go to the New Jersey people because they think that these social programs they are carrying on are good programs, because they have a building they need to renovate.

You are talking about social policies that really don't depend on the tax policy, but they all fell into this.

Mr. CONABLE. Well, Jake, I think the most we can do at this point is promise them we will try to move it as fast as we can here so the rules will be apparent.

Nobody can promise you the date that Mr. Pickle picked will be the effective date because, of course, the Senate has its say, too. A lot depends on how long it takes us to get to enactment. There really is a serious problem in this area. We understand your problem. We have got to do something if we are going to be true to our responsibility to the public to try to see to it that our laws make sense and that tax laws become effective in some way.

We will do the very best we can to move it as fast as possible so you will know the rules. Somebody is going to get caught somewhere, and clearly it is not to the advantage of a sound public policy to have everybody rush to get something started just because the law is going to be changed at some time in the future.

So we have to start with this. It is really a dilemma for everybody concerned. I want you to know we are aware of the problem and we will do the best we can to try to minimize the damages that will result.

Mr. PICKLE. Mr. Albrecht, you are sitting there like we are going to ignore you, and I don't want you to feel that we have overlooked you while we are taking potshots at these other people here.

This question came up earlier in view of your testimony. I ask you, in order now to qualify for the ITC and the ACRS, do planes manufactured by Boeing which are sold to U.S. investors and then leased to foreign users have to fly back and forth to the United States?

Mr. ALBRECHT. That is correct. They do have to be used regularly in service to and from the United States, and I believe the Internal Revenue Service has some guidelines on how frequently they need to land in the United States to meet that requirement.

Mr. PICKLE. Then based on that, they must periodically touch down on U.S. soil?

Mr. ALBRECHT. That is correct.

Mr. PICKLE. Then by way of the ITC and the ACRS benefits, are we not directly subsidizing the competition of our own foreign carriers?

Mr. ALBRECHT. Well, I think, as was pointed out this morning, the rules are really designed to provide equitable treatment between the U.S. carriers and the foreign carriers, because even U.S. carriers have to have their airplanes flying to and from the United States in order to qualify. I think he mentioned Pan Am might have some airplanes that otherwise would fly from other points in the world without coming to the United States.

Mr. PICKLE. It seems to me that Pan Am or TWA do not enjoy the same advantages as in your situation, and they are at a competitive disadvantage.

Mr. **Albrecht**. No. As a matter of fact, I think the U.S. carriers enjoy it because they have these lease arrangements available to them probably with respect to their entire fleet.

With respect to a foreign carrier, it is only that portion of their fleet that serves to and from the United States that has this kind of financing available to it. It is on an airplane-by-airplane basis. The actual airplane must travel to and from the United States in order to qualify, and it also must be registered with the FAA as a U.S. plane.

Mr. **Pickle**. I want to pose a question to the group of you: A U.S. investor would go to France and buy an Airbus and then lease it to Saudi Arabia or some other country, and they could fly their plane and touch it down in the United States and they are registered by the CAB, which complies with our regulations. Now, should we allow those kind of investors who invest in a product made in some other country to get the full ITC and ACRS? Is this the procedure you are trying to protect?

Mr. **Albrecht**. I would not disagree with Mr. Chapoton, who suggested that the origin of the product ought not to be the governing factor on the availability of the ITC.

Mr. **Pickle**. Then you are saying that we ought to let 10 big investors in this country go to France and do that?

Mr. **Albrecht**. No, sir. As a practical matter, all of the long-range aircraft in the world are manufactured by U.S. manufacturers. The Airbus does not have long range, and as a consequence there are not very many of those flying to and from the United States other than those that are owned or operated by Eastern Airlines.

Mr. **Pickle**. Well, since it is not a lot, then don't worry about that then? Should we overlook that?

Mr. **Albrecht**. I would not suggest that. I simply think that we would be making a dramatic change in the rules if we suddenly asked you to protect us by saying a U.S.-manufactured airplane would be entitled to different rules than a foreign-manufactured airplane. I think we would be concerned about retaliatory action by other foreign countries, and we have an international market that we are concerned about.

Mr. **Pickle**. I think it is a question of policy, myself. If you give those benefits to investors who purchase your competitor's foreign-made product, I think you probably would be in agreement, except you all would protect the system.

This great international system of leverage leasing is hard to understand, and our committee is just trying to understand it better ourselves because there is a great deal of inconsistency as to what is being practiced under the program today, and it is costly to our Government. Yet I don't know that I can pin it down solely on the basis of the fact that there are 13,000 direct jobs and 31,000 indirect jobs and, therefore, we will let this leverage leasing go, let it lose.

I can't rationalize it just on the number of jobs, although I recognize it is important and it is a factor like these other aspects out here.

Incidentally, I want to tell the committee that Senator Howard Metzenbaum has introduced a measure or submitted testimony to this committee similar to what we have heard today in support of this bill, H.R. 3110. But he was called out of the city today and could not come here to testify. He wanted to submit a statement in support of the bill, and it will be received by the committee.

[The prepared statement of Senator Metzenbaum follows:]

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM OHIO

Mr. Chairman, I want to commend you and the Committee for pursuing this matter in so expeditious a manner. I wish also to express my support for the legislation introduced by Congressman Pickle to halt a practice known as sale and leasebacks by government and tax-exempt entities. As you know, Senator Dole and I intend to introduce similar legislation in the Senate.

We have witnessed in recent months an explosion in the use of sale and leaseback transactions by governmental agencies and nonprofit entities. With the encouragement of accounting firms, tax lawyers, and trade associations, new deals have been closing almost daily.

Bennington College wants to sell its entire campus and lease it back.

The city of St. Louis wants to sell its city hall.

Baltimore has already sold its incinerator and a firehouse.

Oakland no longer owns its museum or coliseum.

How does the scheme work? Because a city does not pay Federal income taxes it can't take advantage of investment tax credits and depreciation deductions. But a city can sell the building to a taxpayer, who can take advantage of the lucrative tax benefits, and then lease the building back to the city.

Who benefits?

The city benefits because the sale price that it receives is far greater than the amount it must pay to lease back the building in question.

The taxpayer-investor benefits from substantial tax write-offs purchased at bargain basement prices.

But, unfortunately, all of these benefits come at the direct expense of the Federal government and of every American who pays taxes to support that government.

Mr. Chairman, I believe that we must do more to assist our ailing cities and states. We must do more for education at every level. We should continue and strengthen our commitment to revenue sharing, transportation, housing programs and other worthwhile and legitimate Federal efforts to meet the needs of our state and local governments.

But, I do not believe that we should be doing indirectly—through the tax code—the things which we are unwilling to do directly through the Congressional authorization and appropriations process.

The sale and leaseback scheme is a tax gimmick most of whose benefits go to the tax shelter investor. Only a small part of the revenues lost to the Federal treasury goes to the cities, the colleges and the tax-exempt organizations. If it is our intention to assist these organizations and units of government, then it makes no sense whatever to do so in a way that allows tax shelter investors to skim most of the money off the top.

Mr. Chairman, I know that some people are unhappy about the legislation we are discussing today.

We are already feeling the pressure from the lawyers who stand to lose some legal fees.

We are hearing from the real estate developers.

We are hearing from the cities, states, and colleges. And we are even hearing from the foreign governments and foreign companies which are using the tax gimmick to subsidize their activities at the expense of the taxpayers of the United States.

It is always difficult, Mr. Chairman, to shut the gate after the horse has bolted. But if we are going to make any meaningful change in the tax code to prevent this abuse, I believe that the gate should be closed, locked, bolted and forever sealed. And I urge the Committee to move ahead expeditiously to do just that.

Mr. PICKLE. Also, Mr. Joe Moakley of Massachusetts has asked that a statement be made in connection with a project that he was interested in. That will be made a part of the record. I want to be sure that is included in the comments.

[The prepared statement of Congressman Moakley follows:]

STATEMENT OF HON. JOE MOAKLEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. Chairman, I appreciate the opportunity to submit testimony and comment on the bill (H.R. 3110) to amend the Internal Revenue Code of 1954 to deny certain tax incentives for property used by governments and other tax-exempt entities.

I strongly support the intent of the bill, which was introduced on May 24th by Mr. Pickle, for himself and Messrs. Rangel, Vander Jagt, Frenzel, Stark, Gradison, Duncan, Pease, Dorgan, and Martin of North Carolina.

Certainly the gentleman from Texas (Mr. Pickle) is to be commended for his efforts to restrict the growing use of the kind of leaseback arrangements targeted by the bill. Enactment of legislation similar to H.R. 3110 will resolve a serious threat to proper non-profit and governmental accounting and protect the Treasury from unwarranted drain.

But this legislation touches on vital aspects of government financing which have valid purposes and have been sanctioned by Congress in the past for a legitimate cause and I sincerely hope that the Committee on Ways and Means will examime the consequences of this proposal very carefully when it takes up H.R. 3110.

Historically, various benefits under the Tax Code has been used extensively, and with clear congressional sanction, for certain kinds of economic development activities.

As creative accountants in government and other tax-exempt entities have begun to turn these tax incentives to unexpected uses, it is understandable that concerned and responsible legislators like the gentleman from Texas have become alarmed. We have even reached the point at which municipalities are prepared to sell city halls, firehouses, and even sewer and water systems for the sole purpose of shifting certain costs into benefits under Internal Revenue Code.

To the extent that H.R. 3110 takes aim at these devices, it is an entirely proper effort that deserves the serious consideration of this committee. But it is important that these hearings serve as a basis on which the committee can draft an alternative that eliminates potential for abuse, without disrupting total financing arrangements that the Congress has previously recognized as necessary and proper.

Mr. Chairman, I would cite as an important example, activities that have been underway in my congressional district for a decade. In the early 1970's, the Department of Defense abandoned vast, thriving and productive facilities in Boston. The closing of all Naval and Army facilities in the City had a catastrophic economic effect. The closing of these facilities threatened great economic harm to all sectors involved. The Department of Defense found itself with an enormous investment in excess facilities which—because of age, location, and design—offererd limited opportunity to recover on its investment. Both the City and the private sector found themselves staggering under the enormous economic consequences of the sudden loss of facilities which contributed heavily to the employment and other vital underpinnings of the local economy.

The City of Boston originated a long term plan for economic revitalization that involved cooperation by local and state government, the federal government, and the private sector. The conjunction of various federal programs and tax benefits have been a key ingredient in the success of these efforts.

The most recent phase of these efforts is one that deserves to be called to the attention of this committee. Last year, expansion plans by a local university threatened to eliminate several square blocks of aged loft building in the Chinatown neighborhood of Boston, and scores of small businesses housed in them. Without some relocation alternative, which could not be accomplished solely within the private sector, Boston's entire garment industry would have been doomed and thousands of jobs—held by people least likely to find alternative employment—would have been lost from the City and possibly even from this country.

This is a matter in which I have taken a very active personal interest and we have been successful in pushing through a plan to save this industry, and the difficult financing aspects are close to success. The City's economic development agency, in cooperation with the private sector, will acquire and rehabilitate idle facilities at the old South Boston Army Base which are ideally suited to the kinds of light, labor intensive activity now threatened. Without the use of industrial development bonds in conjunction with other benefits under the Internal Revenue Code, this project could never be successful.

Enactment of H.R. 3110, in its present form, could threaten the viability of this project. Any minor and temporary reduction of tax expenditures the bill might produce, in this case, would be completely offset by economic harm that would result from the abandonment of the project. Scores of taxpaying small businesses would be forced to close and thousands of workers would be left unemployed.

I know that this is a result that my friend from Texas would share my eagerness to avoid. And, on the other hand, the unwarranted drain on the Treasury of less justified tax-exempt entity financing schemes is a matter on which I share the gentleman's concern. This leads me to the conclusion that H.R. 3110 presents to the Committee on Ways and Means one of those happy opportunities when sincere legislators can reach a concensus agreement that benefits the Nation as a whole.

Specifically, Mr. Chairman, I would suggest that the committee focus its attention on two aspects of H.R. 3110.

First, there are obvious differences between both the nature and the justification of the plan I have laid before the committee with respect to conversion of the South Boston Army Base and all of the sale-leaseback arrangements discussed at this hearing, involving facilities like the Orange Bowl, U.S. Navy ships, and municipal sewer systems.

Economic development activities, by their nature, must involve cooperative efforts by the public and private sector. And, to the extent that the private sector must be involved in these efforts in order for them to be successful, the tax laws inevitably come into play.

The purchase, rehabilitation, and operation of a city hall, on the other hand, requires no involvement of the private sector. In such a case there is nothing inevitable about the tax laws coming into play, and the involvement of the Code can have no basis other than a deliberate effort to transfer certain costs to the Treasury.

In almost any case that could be presented to this committee to defend H.R. 3110 or to defend current law, these differences would be obvious to each member of the committee.

This committee, and the support apparatus of the joint committee, have the benefit of some of the ablest Members and staff in Congress and I cannot believe that it isn't possible for the committee to undertake that differentiation in advance and to produce a version of H.R. 3110 which provides an adequate definition by which the Treasury and those who would employ these financing plans can determine what kinds of financing arrangements this committee will continue to encourage and what kind it will prohibit.

Second, Mr. Chairman, I would express some concern that section 1(c) of H.R. 3110 is totally unrelated to the basic issues raised by the bill, is not even identified in the bill title, and could seriously disrupt important financing arrangements for which no indication of abuse exists. The bill would deny both historic preservation tax credits and commercial rehabilitation investment tax credits to any projects which benefited from tax-exempt industrial development bonds.

As presently drafted, section 1(c) leads the committee far afield from the purposes and intent of the bill into an area better explored through separate legislation subject to very cautious and detailed committee review. The purposes of this bill, as stated by its title, is "to deny certain tax incentives for property used by governments and other tax-exempt entities." But section 1(c) is of general applicability and would even apply to facilities built or rehabilitated by a private, taxpaying developer for occupancy by a private, tax-paying tenant.

The interests of historic preservation, urban revitalization, and building trades employment have too vital a stake, for this kind of accepted financing to be eliminated by a non-germane provision in an unrelated—and, in many respects, otherwise commendable—piece of legislation.

Mr. Chairman, I appreciate the interest of the committee in my comments. I think, in large measure, that I appear as a supporter of the basic concepts embodied in H.R. 3110 and I hope that the committee can find a way to address some of the concerns I have raised and still responsibly meet the legitimate and important issues placed before it by H.R. 3110.

Mr. PICKLE. Now, Mr. Guarini, you look like you have an interest in this.

Mr. GUARINI. I understand what you are trying to achieve with your bill, and I commend you for wanting to take the abuses out of the program. But to try to put it in its proper perspective, we give several billion dollars a year in tax expenditures out to deferrals of income and various different types of special interests. Perhaps one of the most important special interests that we have is people and human resources.

We have here Martha Lewin, who is active with the YWCA in Jersey City, which is the only Y in that city of a quarter million people. It was to the point of almost being closed because they were virtually bankrupt, $600,000 in tax expenditures meant programs that she testified about, which would have cost the Federal Government a great deal of money over many years will now continue. Programs for runaway kids, battered women, the handicapped, homes for unwed mothers, and many other good works are being done that would cost far more than the $600,000 that the Federal Government is putting up.

I think that we ought to hear from her, and ask her, are there any other good programs that would never otherwise come to fruition were it not for the present law as it exists in helping the social services providers of a community? People are the purpose of our entire Government, and I see where there has been so much good done. If we give a tax expenditure and tax break to timber, which is now almost outdated, I see no reason why we can't give a tax break to unwed mothers, battered women, or to handicapped people.

Do you have any other programs that are in the works, Ms. Lewin?

Ms. LEWIN. We have two others that were——

Mr. GUARINI. Would you please speak up? I really want this to be on the record. We are really talking about our national philosophy, which is very important to me.

Ms. LEWIN. We are developing two other programs at the moment which we would hope to be able to do in a similar way. One is an old Salvation Army building in which we would like to do something that is called cluster housing for handicapped people who would live actually in clusters and services would be delivered to each cluster of handicapped people that would enable them to stay out of institutions and live in the community.

The second program is similar to one we are already doing for girls. We are interested in doing a group home for boys. We already have a contract to provide the service and we are looking at the renovation of a school in Jersey City near the YWCA in which we would do housing and this special group home program for boys.

Mr. GUARINI. Are we talking about buildings that would otherwise never be rehabilitated for any purpose and would stand only as a monument to the poverty of the community?

Ms. LEWIN. I think so. I think that is clear.

Mr. GUARINI. Mr. Stogel, can you tell us how this revitalization of the community can take place? What are the mechanics of it?

Mr. STOGEL. There would be three components to the financing. One would be private capital, which would allow people to share the investment risks and their capital would support a major portion of the construction costs. The balance of it would come from tax-exempt financing.

The reason we must have tax-exempt financing is that we must have tax incentives for the investors—is that Martha's group?—which would be a major tenant in the building cannot pay normal commercial rents, Mr. Congressman, and in order to have her provide quality services and yet meet the rent payments, we need both forms of subsidy.

Mr. GUARINI. Would either of these programs or the YWCA renovation in Jersey City that has been so successful ever come into fruition were it not for the financing that you were able to arrange through these laws?

Mr. STOGEL. No.

Mr. GUARINI. And has this stabilized the community a great deal as a result of having these empty buildings turned into rehabilitated edifices for people to make use of, to live and play in, and to house programs which will make their lives whole again?

Ms. LEWIN. We have seen a tremendous change in the neighborhood since our building has been renovated, investment in both private housing and commercial enterprises along the streets that border the neighborhood.

Mr. GUARINI. I submit, Mr. Chairman, that there are many things that a tax law could address itself to. The most important thing would be to make a community and the Nation work.

Thank you very much.

Mr. PICKLE. Thank you, Mr. Guarini.

Mr. Thomas, any questions?

Mr. THOMAS. No questions.

Mr. PICKLE. Any other members have questions?

[No response.]

Mr. PICKLE. We thank the panel. I am hopeful that the committee might be able to move forward quickly in the consideration of this legislation, not altogether, because you wanted a transition role or new effective date, but because this matter needs to be clearly understood by members and by Congress in order to have a more clearly established policy. I think it is best for all concerned.

So I thank you, the members of this panel, and I appreciate all the other members who have come with us today. It has been a long hearing, but I think it has been very helpful for us.

Thank you very much.

The committee stands adjourned.

[Whereupon, at 4:35 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF HON. BILL SHEFFIELD, GOVERNOR OF THE STATE OF ALASKA

The State of Alaska opposes enactment of H.R. 3110 in its present form. As currently drafted, the Bill provides for extended depreciation recovery periods of 12 years for personal property and 35 years for real property in the case of property used by a tax-exempt entity which was financed by tax-exempt bonds. In addition, extended depreciation periods are specified for property used by tax-exempt entities where the use is pursuant to a lease under which there is a fixed price purchase or sale option which involves the tax-exempt entity, where the entity directly or indirectly protects the landlord from loss on his investment in the property so used, or such use occurs after a sale or lease of the property by the tax-exempt entity and a leaseback.

The provision of the Bill denying accelerated recovery periods for property used by a tax-exempt entity which was financed by tax-exempt bonds is a further attempt to legislate in the area of industrial development bonds to restrict the situations where such bonds may be issued on a tax-exempt basis. Legislation was pending throughout 1981 and 1982 to limit tax-exempt industrial development bond financing. The matter was finally resolved by the passage of TEFRA which enacted several substantive limitations on the use of tax-exempt industrial development bonds effective January 1, 1983. It is submitted that the limitations enacted at that time with the "sun-setting" of the permission to issue tax-exempt industrial development bonds after 1986 was complete and adequate treatment of the situation.

H.R. 3110 will have a very substantial affect on Alaska and on any state or local government which relies on the private sector to finance and build public facilities for governmental use. The Bill in its present form would eliminate an important method by which state and local governments are able to provide essential governmental facilities. It will restrict state or local government to financing public facilities either with cash or the issuance of public bonds.

Many states and municipalities obtain necessary governmental projects through leases from the private sector. The state or local government may not opt to enter captial markets to finance the governmental facility costs through public bonds and may instead wish or need to rely on the private sector to finance such facilities for its use. This kind of financing is appropriate and has been used throughout the State of Alaska to provide essential faciltities for many years.

As noted above, H.R. 3110 would deny accelerated depreciation periods in the case of real property used by a tax-exempt entity financed in whole or in part by tax-exempt obligations. The Alaska Industrial Development Authority has financed numerous facilities constructed and owned by taxable entities but leased by the state, political subdivisions or its entities. These included approximately eleven facilities in locations throughout the State, including Anchorage, Akutan, Valdez, Juneau, Dillingham, and Illiamna. The amounts financed have ranged from $250,000 for an office building in Juneau and Anchorage, with total financings approximating $7.2 million. The space provided by these financing have ranged from 650 square feet to 49,140 square feet. Two proposed financings currently being considered by the Alaska Industrial Development Authority would provide loans in the $8–10 million range each for office buildings in Fairbanks and Juneau.

There is attached to this statement a suggested amendment which would implement the policy set out in this written testimony.

AMENDMENT TO H.R. 3110

At page 5, after line 20, add a new clause (iv) as follows:

(iv) NEW PROPERTY LEASED FOR GOVERNMENTAL PURPOSES.—

(I) IN GENERAL.—The term "tax-exempt use property" shall not include any new property leased by a State or political subdivision thereof or by any agency or instrumentality of a State or political subdivision thereof and used for governmental purposes, if the payment of rent under such lease is subject to annual or biennial appropriations by the elected legislative body of the State or political subdivision.

(II) NEW PROPERTY.—For purposes of this subsection, the term "new property" means property the original use of which by the lessee or any related entity is pursuant to the lease referred to in subclause (I).

(III) GOVERNMENTAL PURPOSES.—For purposes of this subsection, the term "governmental purposes" includes the exercise of any governmental function and any exempt activity described in section 103(b)(4).

STATEMENT OF THE AMERICAN ASSOCIATION OF EQUIPMENT LESSORS

Equipment[1] leasing has become a standard method of providing capital equipment to business, industry and other institutions. Since the early 1950s, the equipment leasing industry has grown to a point that in 1982 equipment lessors provided over $43 billion per annum worth of equipment in the United States economy and several billion dollars worth of equipment in the international economy. This volume of capital equipment is made up of all types of equipment. The range of equipment goes from items valued at several thousand dollars to multi-million dollar equipment installations. Equipment leasing is used by business, industry and other institutions of all sizes.

During much of this period when leasing has become such an important fixture in providing capital equipment, lessors have provided equipment to tax-exempt entities. This practice is not new. Tax-exempt entities have used leasing to acquire equipment because it enabled those entities to obtain equipment efficiently and with the greatest flexibility in managing their equipment needs. In other words, tax-exempt entities lease for the same reasons that 80 percent of the other economic institutions in the United States lease. Leasing is efficient, it's convenient, it's flexible, and it allows companies to obtain the most productive and efficient equipment available. Examples of equipment most commonly leased by tax-exempt entities are medical equipment such as CAT scanners and diagnostic equipment; waste handling equipment and environmental control equipment; firefighting equipment and other safety equipment; construction and maintenance equipment; and, information management equipment including computers. Without the availability of leasing, tax-exempt entities would be restricted in their ability to obtain necessary equipment at the lowest possible price. Transactions to tax-exempt entities primarily have taken two forms:

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[1] AAEL is the major trade association in the multi-billion dollar equipment leasing industry, which accounts for nearly twenty percent of all capital investment each year in the United States. Over $150 billion of gross lease receivables is now outstanding. The membership of AAEL consists of over 700 corporations, which engage in all aspects of equipment leasing. AAEL members are not engaged in the leasing of real estate.

One type of transaction to tax-exempt entities is through a true lease structure in which the lessor is entitled to ACRS deductions. In this type of tax-exempt lease, the income to the lessor is taxable and the lessor pays tax on the income.

The so-called municipal lease is another common type of transaction with government bodies. In this transaction, the lessor provides equipment to the government entity through the form of a lease. This transaction is actually a conditional sale. The lessor does not take any tax benefits of equipment ownership. The income from the government entity (lessee) to the lessor is tax-exempt income in much the same way as interest income from government entities is tax-exempt.

H.R. 3110 primarily addresses the former type of transaction by seeking to deny ACRS to the lessor where the lessee is a domestic tax-exempt entity and replaces it with an extended straight line method of cost recovery.

AAEL supports the general purpose of H.R. 3110 to eliminate abusive lease practices with government or tax-exempt entities. However, the Association believes that the provisions of H.R. 3110 go too far in restricting the ability of tax-exempt entities to utilize leasing as they have traditionally used leasing.

Members of Congress have perceived certain transaction to be abusive. From statements made by the sponsors of H.R. 3110, the primary abuses perceived seem to be transactions of used equipment and plant, usually real estate. There have been no statements to the effect that the leasing of new equipment is seen as abusive. Consequently, H.R. 3110 seems to be primarily targeted at those transactions motivated by tax and fundraising considerations rather than considerations of equipment acquisition. AAEL understands the congressional concern about the potential growth of these transactions motivated by tax and fundraising considerations. While the actual number of these transactions has been relatively small, AAEL understands the concern about a dramatic growth in this area which could lead to an extensive loss of revenue to the Treasury. However, equipment to tax-exempt entities is a common practice. Although the Congress expressly denied the investment tax credit in connection with such transactions, it nevertheless decided to allow the lessor (that is subject to tax on the rental income) to use the existing depreciation system. It is only with the recent growth of certain new kinds of transactions that Congress and the Treasury have expressed concern.

H.R. 3110 creates several other real problems for the traditional use of leases to acquire equipment by tax-exempt entities. Among these problems are the following:

The May 23rd effective date and binding contract test. Where a practice has gone on unquestioned and unchallenged for many years, the setting of an effective date with no warning appears to be arbitrary and catches many bonafide transactions in the middle of completion. If the effective date applied to transactions that had not gone on for years, or if the practice of leasing by tax-exempt entities had been challenged repeatedly, then the establishment of an effective date upon introduction of legislation might be understandable. The nature and structure of lease transactions are such that setting an effective date with no warning or no transition provision makes the two tiered binding contract test almost impossible to meet.

The proposed bill provides that lessors must be obligated to purchase equipment and lessees must be obligated to utilize equipment for a binding contract to exist. While lessors may indeed have obligated themselves to purchase equipment, lessees may not be completely bound to use equipment until actual delivery has occurred even though the lessees have indicated their plans to use equipment. Even when a lessee has agreed to lease equipment and utilize it, the period between the actual agreement and the placed-in-service date may contain points at which the lessee may still back out of the transaction.

Consequently, the setting of an effective date with no warning or transition period, combined with two tiered test of a binding contract, creates undue confusion and hardship for all parties.

Where Congress determines that it wants to change a long-standing policy, the fairer approach and more traditional approach is to specify and effective date as the date of enactment or some other prospective date or even a transition period of some type.

Definition of casual or short-term lease. Equipment used in short-term rentals or operating leases to tax-exempt entities could be subject to the provisions of H.R. 3110. "Casual or short-term" is a vague definition. What is casual or short-term? Further, the provision causes special problems where the same equipment is also rented to taxpayers during a portion of its useful life. If during part of the useful life of the equipment it is rented or short-term leased to a tax-exempt entity, then part of the time to a taxpayer, how is the lessor to treat this equipment for tax purposes? The matter may be complicated further where the use by the tax-exempt entity is in between use by taxpaying entities. Tax-exempt entities who have a particular need for the use of highly technical equipment on a periodic basis are going to find their costs dramatically increased if the provisions apply to those rentals or short-term leases.

Foreign persons as lessees. Historically U.S. leasing companies have leased U.S. registered aircraft, vessels, containers and railcars to foreign lessees and have been able to utilize ITC and ACRS incentives. U.S. lessors have thus been able to provide favorable lease financing for U.S. products abroad. In addition, these U.S. leasing companies are examples of U.S. industries competing with their foreign counterparts. Denial of ITC and ACRS for these transactions, will virtually eliminate a major U.S. industry's ability to compete abroad. On a typical $40 million aircraft lease to a foreign airline for 15 years, the payment will go from $4.6 million per year to $5.8 million per year. A total increase of $18.2 million in cost to the lessee acquiring the equipment over the term of the lease. A twenty-six percent increase.

On other types of equipment leased abroad which have not been eligible for ITC and ACRS, but which is eligible for ADR recovery treatment, the cost impact is also serious. The United States lessor would lose its ability to compete against the manufacturing and leasing companies in foreign countries.

The provisions of H.R. 3110 may require potential foreign lessees to reconsider their decision to purchase U.S. manfactured equipment. While AAEL cannot quantify the accompanying decline in the export of U.S. manufactured goods, it is only reasonable to anticipate that such a decline will occur. The total cost of acquiring an asset must include the implied costs of financing that equipment. By denying the use of ITC and ACRS or ADR to U.S. lessors, the total cost of U.S. manufactured goods compared to foreign products goes up where the potential customer wishes to lease. Considering the larger economic policy of increasing U.S. exports and making U.S. exports more competitive abroad, the Association cannot help but question the much smaller issue involved in this provision of H.R. 3110.

In the statement which accompanies the introduction of H.R. 3110 the bill's sponsors talk about abuses and several unique lease transactions, but there is no indication in the statements that the sponsors view the day-to-day acquisition of new equipment by tax-exempt entities as abusive. With several amendments to H.R. 3110 this legislation could have the effect of limiting or prohibiting those transactions seen as abusive and motivated primarily from fundraising considerations or tax shelter considerations rather than from motivation to acquire equipment. Thus, tax-exempt entities would continue in their ability to acquire needed equipment in an efficient manner. The exemption in the proposed legislation which allows the full use of tax benefits in the sale and lease-back of rapid transit vehicles indicates that where a tax-exempt entity needs to acquire equipment for an important purpose, Congress recognizes that need. This same logic should apply to medical, environmental, information management, safety, and other types of equipment as well as rapid transit equipment.

AAEL makes the following recommendations which could take the form of amendments to H.R. 3110.

Do not apply the provisions of H.R. 3110 to equipment leased within 90 days of when first placed in service. The type of transaction seen as abusive and the type of transaction which could bring a high revenue loss to the Treasury, is the type of transaction which involves real property, not new equipment. Real property is valued much higher and has a longer useful life. Real property can be subject to a succession of sales and purchases with accompanying depreciations. Such is not usually the case with personal property or equipment. Equipment is shorter lived, usually does not have as high a value, and is normally depreciated once. The real need of tax-exempt entities, like taxpaying entities, is for equipment at the most efficient cost. For example, currently a tax-exempt entity such as a hospital leases a $1 million General Electric CT Scanner for $19,175 per month. The lessor utilizes ACRS and pays taxes on the monthly lease income. Under the provisions of H.R. 3110, the monthly payments increase to $21,760. This increase represents an increase of $155,100 or 13.5 percent in the total cost of the equipment.

ADR instead of extended straight line recovery periods. In any event, while the AAEL strongly believes it is in the best interest of the economy to have ACRS for all taxpayers and tax-exempts ordering equipment, Congress may want to restrict the recovery to some degree. If that determination strongly exists, AAEL would recommend that requiring the use of ADR rather than the extended straight line recovery periods is more reasonable. For example, on most equipment there is an ADR system in place which taxpayers can use. Taxpayers are familiar with ADR. Going to a 12-year recovery period for equipment creates several massive problems. Not the least of these problems is the fact that 12 years exceeds the life of most items of equipment. Since tax-exempts use leasing to acquire equipment which is most frequently high tech state of the art equipment, a 12-year recovery life would dramatically exceed the useful life of such equipment. However, using the ADR system would be much more realistic in terms of the useful life of the equipment and would not impose yet another set of recovery periods on the tax code.

Quantifying the short-term or casual lease. Some measure should be determined which taxpayers can use in determining the existence of a short-term or casual lease. Such a figure would resolve the problem over multiple lessees, some of whom are taxpayers, some of whom are tax-exempts. AAEL apply if the equipment is used by a tax-exempt entity more than 50 percent of its present class life.

Foreign lessees. AAEL believes that all provisions related to foreign persons, including foreign corporations owned by foreign governments, as lessees should be withdrawn for further study. The Association submits that this is not the time for congress to take any step which makes U.S. financing and U.S. products less competitive in world markets. The current practices which have existed for many years, have been one of the advantages of U.S. companies competing abroad.

Effective date. Make the effective date prospective. The date could be January 1, 1984 or the date of enactment, or the bill could provide a transitional period. However, the date would be an advance notice and would eliminate arbitrary treatment with its accompanying confusion. Because leasing to tax-exempt entities has been a continuing and recognized form of equipment acquisition for such a long time, the date of May 23rd, one day before the bill was introduced, should be changed.

Test for binding contract. The AAEL believes that the nature and structure of lease transactions dictates that the test for binding contract be a single tiered test rather than a two tiered test. The Association suggests that since the taxpayer is the lessor that the test should be on the lessor. If the lessor or his predecessor in interest have a binding obligation to acquire the equipment which will be subject to the lease prior to the effective date of the provisions of H.R. 3110, then it should be determined that a binding contract exists.

In conclusion, AAEL agrees with the statements of intent made by the sponsors of H.R. 3110 insofar as the sponsors of the legislation seek to limit transactions perceived as abusive. However, the Association respectfully submits that the Congress should not pass legislation which limits or eliminates long-time practices used by tax-exempt entities to acquire new equipment. These transactions have existed for a long time. Neither the Congress nor the Treasury has regarded them as abusive heretofore and they should not now be caught in an effort to limit transactions which are seen as abusive. By adopting several amendments to H.R. 3110 as originally introduced, the Congress can limit the perceived abuses and yet allow tax-exempts to have continued access to new equipment at an efficient cost.

AMERICAN CONSULTING ENGINEERS COUNCIL,
Washington, D.C., June 10, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: The American Consulting Engineers Council (ACEC) is pleased to provide these comments on H.R. 3110, the "Govermnental Leasing Tax Act of 1983", for the printed hearing record.

BACKGROUND

ACEC is an organization of over 3,800 consulting engineering firms with nearly 120,000 employees, located and practing in all 50 states. A majority of our firms are involved in providing engineering services to federal and state agencies, municipalities and special-purpose districts, including planning and design of public utilities as well as buildings and other facilities.

As first-line technical advisors to state and local governments, consulting engineers have been in a first-hand position to witness the critical dilemma of counties, cities and districts who, for a number of years, before "infrastructure" became an attractive political issue in Washington, have been attempting to cope with three coincident and somewhat conflicting concerns—deteriorating public facilities, lack of federal program and budget discipline and public-imposed constraints on local revenue-raising authority.

SUMMARY OF POSITION

With this background, we strongly support continued availability of the depreciation and tax credit incentives as established in the Economic Recovery Tax Act of 1981 for innovative financing of essential public utilities by state, local and special-purpose governmental entities and urge that H.R. 3110 be modified appropriately.

COMMENTS ON SUBCOMMITTEE REPORT ON "TAX AND BUDGET ISSUES RELATED TO LEASING BY NONTAXABLE ENTITIES"

Federal leasing

Since the introduction of H.R. 3110 is largely predicated on the findings and recommendations of the report of the Subcommittee on Oversight, following are our comments.

Generally, we take exception to the report's singular focus on the impact of revenue losses resulting from the conferring of tax benefits obtained through leasing by state and local government. As a practical matter, a conclusive policy analysis to assess the impact of federal "lease versus buy" decisionmaking should focus not only on revenue loss, but counterbalancing federal capital expenditure reductions.

The limited "case history" analysis in the analysis in the Subcommittee's report is insufficient to support the conclusion that federal long-term leasing is more costly than outright purchase. We would suggest, for example, that it is essential to factor long-term operations and maintenance (O&M) costs into the equation; it would be helpful if the Subcommittee was to assess the comparative costs of federal and private operation and maintenance of essential public utilities. For example, the U.S. Army Corps of Engineers has analyzed the comparative O&M costs associated with recreation facilities at authorized projects and maintenance dredging of ports and waterways.

The report's conclusion that federal purchasing is less costly than long-term leasing is also based on the notion that since the federal government can stand at the head of the line in the borrowing markets, it gives away the advantage of lower interest rates owing to its "superior credit" when it leases. If this convoluted perspective were carried forward, there would be no reason to constrain goverment from ownership or operation of any enterprise. It is true that government in general goes before private borrowers in the credit market by trading on the trust and confidence of its constituents, but that does not necessarily represent the most effective or prudent use of available credit.

With respect to OMB adoption of guidelines for assessing the financial impact of governmentwide leasing, we agree that it would be desirable to provide a regular analysis of proposed "lease-buy" decisions. However, such analyses should focus on all identifiable costs and benefits and not simply the revenue loss.

In this regard, the accounting method summarized in Table 1 of the report does not fully depict ". . . an analysis of total government costs . . ." as related to public utilities. We would suggest the following modifications:

TABLE 1.—ECONOMIC ACCOUNTS, LEASE VERSUS BUY

Agency finance method	Agency		Treasury		Government net cost or benefit
	Cost	Benefit	Cost	Benefit	
Lease	Rent residual	Capital O&M cost savings [1].	Tax benefits [a]	Tax benefits [a]	Rent plus residual plus tax benefits: Capital and O&M cost savings Tax benefits

TABLE 1.—ECONOMIC ACCOUNTS, LEASE VERSUS BUY—Continued

Agency finance method	Agency		Treasury		Government net cost or benefit
	Cost	Benefit	Cost	Benefit	
Buy	Purchase prices, O&M costs.	Lease cost savings	Tax benefits [4]	Tax benefits [5]	Purchase price plus O&M costs plus tax benefits: lease cost savings tax benefits

[1] At an amortized rate, based on useful facility life.

[2] Tax benefits offset by use of ACRS and ITC.

[3] Tax benefit derived from lessor.

[4] Tax benefits foregone as a result of public versus private facility ownership.

[5] Tax benefits retained (ACRS and ITC) as a result of public ownership.

State and local government

With respect to limiting cost recovery deductions to state and local governments as a means of making leasing less attractive than direct ownership, we believe that this would be an undesirable policy step.

As the Committee knows, the problems of state and local government entities in financing and maintaining public utilities and other capital improvements are very real. These problems stem largely from (1) capital facilities deterioration; (2) discontinuity and uncertainty in federal program commitments; (3) impact of federal borrowing; and (4) local constraints on local revenue-raising authority.

Leading authorities have clearly documented the decline in the federal commitment to non-defense capital facilities which began in the mid to late '70s. The examples of "stops and starts" in federal program commitments—including the EPA Construction Grants Program, the federal-aid highway program, the airport/airways development program and economic development assistance—are legion and the latest "false starts" concerning New Federalism and grant consolidation have added to state and local uncertainty as to federal commitment. The impact of federal deficits is such that the federal government has used its "superior credit" to step in front of other levels of government as well as private borrowers, reducing the viability of state and local bond financing. And unquestionably, local and statewide "economy in government" initiatives have constrained revenue-raising capabilities.

With this background, state and local governments and their engineering and financial advisors are beginning to creatively and productively utilize the ERTA capital investment incentives to "package" priority public utilities projects, particularly water and wastewater treatment facilities, needed to satisfy public health, safety and welfare requirements (often based on federally-mandated standards). From the perspective of this early experience, we can already point to the following advantages:

(1) Reduction in project delivery times (due primarily to reduction in governmental regulation and reviews); (2) a greater sense of "equity" on the part of the state and/or local governmental project sponsor; and (3) the attractiveness of the investment potential.

We anticipate that over time this approach to public utilities financing will facilitate the needed transition to a stronger state and local government role in public utilities capital planning and development, with a corresponding reduction in the level of federal program management, regulation and financing. Given the recent Office of Management and Budget statistics, in the United States as an average, state and local costs (not including overhead and administration) associated with federal grants-in-aid amount to $0.45 for each $1.00 in federal funding. With this in mind, from a policy standpoint, it may be desirable to provide these tax incentives in lieu of federal outlays for grant-in-aid. We would therefore suggest that it is as least equally possible that use of ACRS and ITC incentives in public utilities financing may be more, rather than less, efficient in aiding state and local governments. As to the "aid" ". . . absorbed by inter-mediaries involved in structuring the lease . . .", one would have to weigh such "aid" against the cost of turning each dollar in federal tax revenues back to the states and localities as grants—our supposition is that this cost is fairly high.

Finally, it is our view that state and local government entities are not likely to circumvent public participation or requirements associated with the grants-in-aid process by using these incentives in public capital facilities development. Since the use of these "tools" is likely to provide financial resources equivalent to a 50-to 60-

percent federal grant, it will still be necessary in virtually all cases to provide a measure of bonding or tax-based financing requiring formal and informal public involvement to complete the financing "package".

SUMMARY

In summary, Mr. Chairman, we believe your Committee acted with great wisdom and foresight in providing these incentives in the Economic Recovery Tax Act of 1981. We are encouraged that the use of the ACRS and investment tax credit incentives can and will be useful in bridging the state and local revenue shortfall associated with critically-needed public utilities development. We strongly urge you to endorse this use of those incentives for essential public facilities development in your further action on H.R. 3110.

Please feel free to contact us if we can provide future specific information or answer any questions.

Very truly yours,

William J. Birkhofer,
Director, Governmental Affairs.

Baker & McKenzie,
Washington, D.C., June 10, 1983.

John J. Salmon,
Chief Counsel, Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

Dear Mr. Salmon: On behalf of the American Geological Institute ("AGI") we are submitting this statement in commection with the hearings held by the Ways and Means Committee on June 9, 1983, with respect to H.R. 3110, The Governmental Leasing Tax Act of 1983.

Without expressing an opinion with respect to the general thrust and substance of H.R. 3110, AGI strongly believes that the effective date provisions of this proposed legislation, as presently drafted, are manifestly unfair and would impose a severe financial hardship on many tax exempt organizations, such as AGI, which may not have entered into binding contracts on or before May 23, 1983, but which have made significant commitments to projects on the basis of the existing state of the tax law.

In this regard, the facts relating to AGI's particular situation reveal the inequity of the effective date provision. AGI was formed in 1963 for the purpose of advancing the science of geology and geophysics by disseminating information to geoscientists, educators and students. AGI is organized and operated exclusively for charitable and educational purposes and has been recognized by the Internal Revenue Service to be exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code and, further, has been determined to be a public charity and not a private foundation.

AGI had for many years occupied rental office space in Falls Church, Virginia. In order to acquire additional office space for planned expansion of its operations and, at the same time, escape ever escalating rental payments, on December 15, 1982, AGI purchased title to land and an office building that was scheduled for completion and occupancy on September 1, 1983. AGI financed this purchase partially with $1.6 million in industrial revenue bonds issued by the City of Alexandria and provided the remainder of the purchase price, $525,000, out of its own funds. At the time that it made this purchase, it was AGI's intent that its $525,000 investment would be only temporary and that it would recoup this amount by later entering into a sale/leaseback arrangement with a limited partnership. In this regard, AGI felt that it could not afford to make such a large expenditure of its operating funds and, in fact, would not have acquired this building without the prospect of being able to recoup its $525,000 downpayment from the limited partnership. Under the contemplated sale/leaseback arrangement (which is anticipated to be consummated on or before September 1, 1983), AGI would sell the building to the limited partnership and simultaneously lease the building back, retaining an option to purchase the property for its fair market value at any time after the tenth year of the lease.

This transaction appears to fall within the scope of H.R. 3110's provisions. Consequently, if H.R. 3110 is eventually enacted the limited partnership would be required to recover its cost of the property on a straight-line basis over a 35-year recovery period. This would, of course, significantly reduce the attractiveness of the proposed sale/leaseback arrangement and, in all likelihood, would prevent its consummation and leave AGI in a precarious financial position.

AGI submits that it is inequitable to subject it and similarly situated tax exempt organizations to such a major change in the tax law at this late date. As noted above, AGI would not have purchased the building and paid $525,000 out of its own funds without the prospect of being able to finance the acquisition with outside funds, and AGI relied on the existing tax laws in structuring its method of acquiring the use of the building. By changing a major aspect of the tax law that AGI had in good faith relied upon in structuring this transaction, Congress would be imposing a severe and unavoidable financial hardship on AGI.

While the "binding contract" exception contained in H.R. 3110 is a step in the right direction, it fails to give relief to those organizations, such as AGI, which had made significant commitments of funds toward a particular project but which, for one reason or another, had not yet entered into a binding contract with respect to the actual "use" of the property. Accordingly, AGI proposes that the Committee expand the binding contract exception to include binding contracts entered into by tax exempt organizations on or before May 23, 1983, to purchase property with an intent to subsequently enter into a sale/leaseback transaction with respect to that property. Whether the requisite "intent" exists in any given situation could be determined on a case-by-case basis taking into account all of the facts and circumstances. This approach would allow tax exempt entities that have made substantial financial commitments in connection with contemplated sale/leaseback transactions to finance their projects as planned, thereby avoiding the unforseen and inequitable tax consequences that would be imposed by H.R. 3110.

We urge the Committee to give appropriate consideration to this small but significant amendment to H.R. 3110 and to incorporate the suggested changes into that or any similar bill adopted by the Committee. We believe this provision will bring an important measure of equity into what may otherwise be an acceptable piece of legislation.

Sincerely,

BERTRAND M. HARDING, JR.

STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

The Associated General Contractors of America and its 112 chapters nationwide is comprised of approximately 32,000 firms including 8,500 of the nation's leading general contracting companies that perform more than $100 billion of construction annually. AGC member firms normally employ some 3,400,000-plus workers, a significant portion of our national labor pool.

H.R. 3110 would reduce the tax incentives which make private financing of public works facilities attractive by requiring straight-line depreciation over extended recovery periods for property used by tax-exempt entities. The bill would also tighten the present law denial of investment credits for this property. If enacted this legislation could severely impact the effort to rebuild the country's aging infrastructure facilities.

Since June of 1981, the Associated General Contractors of America has been alerting the public to the steadily deteriorating infrastructure in the United States. AGC has surveyed existing literature and studies on infrastructure needs and contacted over 100 organizations, states and cities in an effort to develop a documented estimate of necessary investment to meet presently identified infrastructure needs. The AGC research reveals a minimum necessary capital investment of approximately $33.03 trillion. While the time frame for addressing such needs varies in the individual infrastructure categories, a weighted average indicates that most investment is projected to be necessary within the next 19 years.

Public works investments at all levels of government generally account for approximately 24 percent of all new construction put in place, or approximately $56 billion based on the 1982 value of construction put in place. Continuation of such inadequate public works investment levels would produce over the next 19 years (in 1982 dollars), a total investment of $1.06 trillion compared to the minimum necessary investment level of $3.03 trillion—a total shortfall of approximately $1.97 trillion and an annual shortfall of $104 billion in 1982 dollars.

The AGC study reveals the diversity and complexity of funding needs. It also reveals that no single answer, no single investment strategy, no single funding mechanism will suffice. Each level of funding authority and responsibility has a role to play in devising a program to increase public capital investment.

One funding mechanism which will play an important role in the rebuilding effort is the concept which has come to be called "privatization." Under such an arrangement private companies, either individually or as a group, undertake the financing, construction and operation of a facility which has traditionally been the responsibility of the local governing body. Wastewater treatment facilities, in particular, are likely candidates for this type of funding arrangement.

In this era of reduced federal budgets and community moves to cut local taxation, municipalities and counties are finding it increasingly difficult to meet public works requirements. Many local governments are reaching their debt ceilings and therefore will not be in a position to borrow money in the bond market to finance these projects.

In much of the literature dealing with our existing infrastructure crisis, it is apparent that much of the problem can be traced to deferred maintenance. This deferral has resulted from the lack of available funds. Traditional funding of public works projects are highly politicized and do not always result in the best long-term decisions. Privatization can help remove the issue from the political arena to the business arena without, however, removing it from public scrutiny.

Because of the significance of privatization to the infrastructure rebuilding effort, AGC cautions strongly against passage of H.R. 3110 without certain exemptions. The intent of the legislation is to eliminate lease-back arrangements which offer the use of various tax incentives by tax exempt entities. When enacted these tax incentives were intended to motivate reindustrialization and new capital investment. It appears that the rationale for H.R. 3110's elimination of these arrangements is they are nothing more than paper work shuffles and do not provide for reindustrialization and new capital investment. In the case of new public facility construction and operation, however, this is not true, particularly in the case of wastewater treatment facilities. Construction of a public work facility is a significant type of new capital investment which spurs additional industrial development.

AGC urges that in acting on H.R. 3110 serious consideration be given to the need for the privatization concept as an alternative financing mechanism for rebuilding the infrastructure. AGC urges that H.R. 3110 be amended to allow for the use of these various tax incentives for the construction of public works facilities.

STATEMENT OF AUSTRIAN, LANCE & STEWART, NEW YORK, N.Y.

EFFECT OF H.R. 3110 ON AMERICAN LEASING ACTIVITIES OVERSEAS

On May 24, 1983, a bill was presented to Congress that, if enacted, would significantly alter existing capital recovery methods for assets owned by United States taxpayers and leased aboard. We urge that Congress consider and take the necessary steps to correct what would appear to be the unintentional but nevertheless devastating impact of certain provisions of that bill, H.R. 3110, 98th Cong., 1st Sess., the "Governmental Leasing Act of 1983" (May 24, 1983), on, among other things, United States exports. The effect of the proposal would at the very least greatly discourage American leasing activities with foreign lessees, even though those leasing activities account for approximately $125 billion of American manufactured exports, including aircraft, natural resource exploration machinery, computers, construction equipment, and other categories of capital equipment being used abroad today.

In introducing the Governmental Leasing Act of 1983 Representative J. J. Pickle of Texas stated that his purpose was "to stop one of the most unusual, ingenious, and costly tax shelters that we've seen in years.' He identified the leasing of existing assets owned by colleges, other charities, and local government authorities as intended targets of the bill. He also stated that certain agencies of the Federal Government were entering into leveraged lease transactions that would cost the Treasury more than the cost to the agencies to purchase the same property, and he cited the Accelerated Cost Recovery System ("ACRS") as providing the impetus for these practices by creating a tax incentive to own and lease capital assets.

Unfortunately, the language in the bill would not only eliminate the abusive activities cited by Representative Pickle, but may also cripple American leasing activities overseas by replacing a net income tax system (taxing a reasonable estimate of income from a business transaction) with a system of tax penalities (taxing a business transaction based on income greater than it produces). This is so even though those activities only rarely enjoy the subsidies afforded by ACRS and were not a target of the proposed legislation either specifically or in concept. Indeed, the efforts of the leasing industry are cited by the United States Department of Commerce as one of the prime reasons that American manufacturers of capital goods can compete overseas against foreign manufactured capital equipment even though foreign competition is often heavily subsidized by the manufacturer's government.

Under current law, in almost every instance United States entities investing capital to lease American equipment abroad do not receive the investment tax credit or other tax benefits of ACRS given to lessors of equipment domestically. On the contrary, with respect to the huge market that is the focus of this letter, American lessors of equipment abroad can recoup their capital only over the anticipated true useful life of the asset. (See "Capital Cost Recovery and the Proposed Legislation", infra p. 6). This has already placed the foreign leasing activities of American lessors at a considerable disadvantage relative to domestic leasing.

The thrust of H.R. 3110 is to discourage those leasing activities outlined in the bill's preamble which are viewed as having a substantially negative budgetary impact. Unfortunately, even though not yet enacted, H.R. 3110 has already had the effect of severely curtailing United States leasing activities overseas, notwithstanding that those activities are not the target of the proposal.

As a result, the following benefits to the United States economy are placed in jeopardy:

(1) Exports of United States manufactured goods ($125 billion of American equipment is leased abroad today); (See infra p. 17); (2) Income generated by the international leasing activities of United States corporations, which totalled $13.4 billion in 1981 alone; (See infra p. 16); (3) A $10 billion positive contribution to the United States balance of trade; (See infra p. 23); (4) The maintenance of the large overseas secondary market for used American manufactured equipment (See infra p. 34); (5) The expansion of the United States working capital base from which additional investment can be made (See infra p. 30 et seq.); and (6) United States employment opportunities which have been directly created through international leasing activities (See infra p. 16 et seq.).

This letter will contain two sections which will contain respectively discussions of: (a) The system of capital cost recovery under current law and the proposed legislation as it affects current tax policy; and (b) the huge scope of American-leasing activity overseas, and its benefits to the economy and the United States Treasury, based upon the most current statistics from the United States Department of Commerce and other relevant sources.

We will demonstrate that existing law insofar as it relates to almost all of the assets leased to non-United States taxpayers does not result in any abuse of federal income tax policy of the sort which inspired the proposal but merely provides a reasonable means for recovering capital invested abroad in income producing property.

The introduction of this bill has already had a chilling effect on the sale of American manufactured equipment, including the postponement of the sale of over $150 million of aircraft of which we are aware. In view of the role that leasing plays in American exports, discussed below, it may be wise to consider foreign property used in foreign countries separately. That could be accomplished by removing non-United States persons from the definition of "tax-exempt entity" and from the scope of the investment tax credit provisions of the bill.

In the alternative, we urge that the proposal be amended to exempt property which does not now receive the benefits of the investment tax credit or accelerated cost recovery afforded by ACRS. Attached as Alternative B is a simple amendment to the proposal exempting from penalty property whose cost is recovered under Code section 168(f) (2). We have also submitted for your consideration as Alternative A a draft of statutory amendments which remove tax incentives from ownership of all of the stated targets of the legislation without imposing tax penalties.

CAPITAL COST RECOVERY AND THE PROPOSED LEGISLATION

The proposed Governmental Leasing Act of 1983 as drafted not only denies tax benefits in situations described by Representative Pickle as abusive of ACRS, but also penalizes taxpayers engaged in many legitimate commercial leasing transactions who, under ACRS rules relating to property used predominately outside the United States, presently recevie no tax subsidy. The bill will tax United States lessors of this type of property on more than their net incomes. Taxing an amount greater than income is a penalty contrary to the philosophy of the Internal Revenue Code of 1954, as amended (the "Code"). It should be noted when examining deductions available to lessors or property used abroad that under present law no cost recovery deductions are available to the United States owner of such property unless the income from it (either from the owner's use or lease rents) is subject to tax in the United States.

The bill would require that the capital cost equipment leased abroad be recovered only by straightline depreciation over a period unrelated to, and often far in excess of, its useful life. That has the unintended and deleterious effect of creating a tax disincentive to commercially desirable transactions.

For most domestic equipment, ACRS replaced the "class life" asset depreciation range system ("ADR"), a system which attempted to tax the net income arising from the ownership of capital assets by allowing taxpayers to recover the cost of investments in property based upon its anticipated useful life as determined by the Government. The Office of Industrial Economics was created at the same time as the ADR system to make such determinations. That office also established and adjusted asset depreciation ranges and repair allowances for ADR assets. Capital costs recovery deductions for new property could be calculated using the 200 percent declining balance method, reflecting the rapid decline in value of property when it is initially placed in service. Salvage values were required.

When Congress adopted ACRS it increased the tax benefits of owning domestic property without extending similar benefits to foreign property. Among the objectives cited for creating ACRS were the stimulation of capital formation, simplification of compliance by taxpayers and administration by the Internal Revenue Service, and improvement of the nation's competitiveness in international trade. (See Staff of the Joint Committee on Taxation, "General Explanation of the Economic Recovery Tax Act of 1981", at 19 and 75, December 31, 1981). The cost of most domestic property, which under ADR would have been recovered over periods ranging generally up to 20 years, can be recovered over only 5 years. The cost of that same property, if located abroad, continues to be recovered over its anticipated useful life under the ADR system, now called its "present class life". Code section 168(f)(2). In keeping with Congress's intent to make capital cost recovery a simple system, both new and used property located predominately outside the United States became eligible for the 200 percent declining balance method and the concept of salvage value was eliminated.

Prior to ACRS, if a taxpayer placed into service a new commercial aircraft used predominately within the United States and elected to recover his cost through the ADR system, he would depreciate it over 12 years (plus or minus 2.5 years), and could calculate his deductions using the 200 percent delining balance method. In addition, he could earn an investment tax credit equal to 10 percent of his cost. If the taxpayer placed the same aircraft in service abroad, he would depreciate it over its asset guideline period, 12 years, and use the 200 percent declining balance method. He would not be entitled to the investment tax credit. Other than the denial of the investment tax credit, the tax treatment of domestic and foreign property was much the same.

Under ACRS, the tax consequences of owning the same commercial aircraft become more favorable if it is used predominantly within the United States. The taxpayer recovers his entire cost over a five-year period and claims an investment tax credit equal to 10 percent of his cost. If he places the aircraft in service abroad he must recover his cost over a 12 year period and may use the 200 percent declining balance method. Again, no investment tax credit is available.

Under ACRS, the tax treatment of ownership of leased property is clearly more favorable if it is used domestically rather than abroad. That seems consistent with the desire on the part of Congress to create incentives for the ownership of property used domestically while retaining a simplified net income tax system to recover the cost of property used abroad. In 1981, Congress had before it a proposal to depreciate property used predominantly outside the United States over the period used for corporate earnings and profits (See H.R. 2400, introduced March 10, 1981). Congress instead elected to retain a net income tax system for such property by simplifying ADR. As applied to leased personal property, that difference in tax treatment can be justified in that income from both the lease and domestic use of property is subject to United States tax, while for property leased abroad generally only the income from the leasing activity is subject to United States tax.

Under present law, certain property leased to tax-exempt users including non-United States tax persons is eligible for the tax benefits of accelerated cost recovery and the investment tax credit, which is what Representative Pickle seeks to prevent. That property includes property used pursuant to service contracts by charitable organizations and governmental agencies and property used by non-United States persons with United States source income not subject to United States tax (for example, because of an exemption provided by a tax treaty). Although a user's income from the operation of a commercial aircraft may be exempt from taxation, the aircraft may be treated as used predominantly within the United States if it is registered with the Federal Aviation Administration and makes regular flights to and from the United States. (Code section 48(a)(2)(i)).

Unfortunately H.R. 3110 not only prevents the owner of that type of aircraft from claiming the investment tax credit and accelerated cost recovery but makes that owner and any owner of property leased abroad subject to a tax penalty rather than allowing him to recover his investment over the property's useful life. Although that is not the aim of the legislation, its effect is to change a system of net taxation into one which offers a mixture of incentives and penalties. This would have the undesirable effect of discouraging leasing transactions entered into for non-tax reasons or of encouraging lessors to move their activities offshore. In either case, no income subject to tax from the use of that property would be generated and, furthermore, income from the lease transaction would be lost.

The Subcommittee on Oversight of the House Committee on Ways and Means held a public hearing on February 28, 1983. The Subcommittee focused on leasing arrangements entered into by the Navy under the TAKX program and by other tax-exempt users. The proposed legislation reflects some of the views and recommendations arising out of that hearing. For instance, the Subcommittee stated that it was concerned about leasing transactions by non-taxable entities "which involve ACRS and ITC tax benefits." Again, the foreign leasing activities discussed herein in almost all instances do not involve accelerated cost recovery or the investment tax credit. The Subcommittee also noted, however, that there are non-tax reasons for entering into leases, and that some long-term leasing arrangements, even by governmental or tax-exempt entities, are not "necessarily inappropriate." See Subcomm. on Oversight, House Comm. on Ways and Means, 98th Cong. 1st Sess.; WMCP: 98-7 at 15 (Comm. Print, May 25, 1983). ACRS in its present form is an administratively convenient, understandable system of cost recovery that provides tax incentives for ownership of certain assets while taxing the rest on a net basis. There are appropriate non-tax reasons to enter into leases of property located abroad. While denial of accelerated cost recovery deductions and the investment tax credit to owners of property located abroad may be appropriate, the imposition of a tax penalty is undesirable. The Code does not otherwise impose penalties for engaging in legitimate business activities. Moreover, the proposal complicates our system of cost recovery and erodes the concept of net taxation. A cost recovery system resulting in the net taxation of transactions to which Congress does not wish to grant tax incentives is fair and would not discourage leasing transactions which are otherwise appropriate.

In the light of the positive effects upon the United States economy generated by the leasing of property abroad, as discussed in detail below, it may be desirable to retain tax incentives for certain exported property. Should Congress wish to consider foreign leasing activities separately from other leasing, we suggest carving foreign leases out of the bill by removing non-United States persons from the definition of "tax-exempt entity" and from the scope of the investment tax credit proposal.

Attached as Exhibit I are drafts of proposals for your consideration. Alternative A is a proposal which, together with paragraph (b) of H.R. 3110, would deny accelerated cost recovery and the investment tax credit to those lease transactions outlined by Representative Pickle and the Subcommittee on Oversight as not deserving of tax incentives. It does not penalize transactions now taxed on a net basis as to which Congress does not wish to grant tax incentives. ACRS has created tax incentives for domestic equipment, a net tax system for foreign equipment, and for both taxpayers and the government a simplified system of cost recovery. By extending the scope of Code section 168(f)(2) to assets which are the target of the proposed legislation, the simplicity of ACRS is retained and the assets do not receive the incentives of the investment tax credit and accelerated cost recovery. If, however, the bill is enacted in its present form, the owners of some property would receive tax incentives, owners of other property would be taxed on a net basis, and owners of still other property (most of which are not now granted tax incentives) would be subject to a tax penalty. Alternative A retains the simplicity and fairness of ACRS.

Alternative B is a less comprehensive proposal. A simple addition to the proposal exempts from tax penalties transactions which do not now result in the investment tax credit or accelerated cost recovery. It does so by exempting from the penalty provisions property governed by section 168(f)(2).

Attached as Exhibit II is a chart which illustrates various methods of cost recovery. It compares the tax results of an investment in a bus eligible for the investment tax credit under the ADR system as it existed before ACRS, ACRS for domestic property, H.R. 3110 for property subject to the proposed penalties, and either Alternative A or B (Code section 168(f)(2) in its present or an expanded form).

THE IMPACT OF H.R. 3110 ON THE EXPORT OF AMERICAN MANUFACTURED GOODS AND THE BALANCE OF TRADE

The discussion which follows is divided into three parts. The first examines the extent to which lease structures are used to finance American exports in general and the devastating effect that H.R. 3110 would have upon the sale of American manufactured goods for use abroad.

The second examines the anticipated effect of the bill upon two major industries that share many common characteristics: civil aircraft and computer equipment. Both are large employers, account for a large share of American exports and make heavy use of lease arrangements in connection with export of their goods. In both industries, United States dominance is now being severely eroded or challenged primarily because of financing and other subsidies made available by other nations to their domestic manufacturers. Both industries require large expenditures for research and development which, in foreign nations, is often financed by governmental or quasi-governmental agencies and which, in the United States, can only be financed out of profits. Finally, in both industries leasing is a valuable tool for reasons other than financing. Generally, users lease aircraft or computers to avoid borrowing or capital expenditures that would impair their working capital and to avoid committing large sums of money to equipment that may soon become obsolete. If the availability of leasing is eliminated or made prohibitive, those users would not buy as an alternative unless they had no choice. In both cited industries users do have a choice. In aircraft the alternatives to American products include Airbus Industrie's widebodies and in computer equipment the increasing alternatives are Japanese products which are competitive with IBM equipment.

In the third section we discuss the effects of the proposal in the United States balance of payments, and other related consequences.

A. The effect of American foreign leasing activities on exports

International equipment leasing encompasses both local-overseas and cross-border transactions. According to the United States International Trade Commission ("USITC"):

There were at least 60 major United States equipment leasing firms with extensive international operations in 1981; foreign revenues of United States leasing activities amounted to $13.4 billion in 1981, and are projected to have exceeded $17 billion for 1982: of between $200 and $250 billion in total value of equipment on lease worldwide, approximately $125 billion is of American manufacture, and of that, the portion leased directly by domestic firms exceeded $46 billion; and United States leasing firms represent 75 percent of the world cross-border leasing market.

United States International Trade Commission, "The Relationship of Exports in Selected U.S. Service Industries to U.S. Merchandise Exports," USITC Publication 1290, pp. 143–157 (Sept. 1982).

In its October, 1982, report on "The Equipment Leasing Industry in the United States", the United States Department of Commerce recognized that "in fact, the bulk of all equipment leased in foreign countries is of U.S. origin which directly enhances further exports." United States Department of Commerce, Bureau of Industrial Economics, "The Equipment Leasing Industry In The United States," (October, 1982), at 53.

In a 1976 policy statement the Department of Commerce estimated that products of United States origin accounted for more than 50 percent of all leased assets outside of the United States [1] (or $100 to $125 billion of American-made goods). That preeminence cannot be sustained if, while competitive industrialized nations are encouraging export financing with subsidized borrowing, the United States is considering hampering those exports by imposing capital recovery guidelines that effectively eliminate the ability of American manufacturers' to arrange competitive financing for their products. As noted above, the Accelerated Cost Recovery System currently affords no subsidy whatever for the use of assets abroad.

The ability under existing law to arrange attractive lease financing programs for foreign lessees has been a prime factor in the albeit precarious dominance of the international market by United States export products. Existing law has met the needs of such users in fields as diverse as civil aviation, natural resource exploration and transmission, data processing and telecommunications.

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[1] United States Department of Commerce, Office of the Assistant Secretary for Policy, U.S. Service Industries in World Markets: Current Problems and Future Policy Development (December, 1976).

There are already indications that the value of leased foreign goods has increased at an annual growth rate 8 to 10 percentage points greater than the rate of increase for American-made products. (United States International Trade Commission, supra at 146).

Any further decline in demand for United States goods will reduce employment in the already overcrowded industries most likely to be affected: aerospace and data processing.

The limited economic recovery we are experiencing at home has resulted in the relative strengthening of the dollar overseas. The strength of the dollar, however, has made United States manufactured goods more expensive than those from other markets. In order to prevent any backsliding and to offset high prices for their export products, domestic suppliers are required to provide alternate funding mechanisms for their customers, including reliance upon financing afforded by current leasing formulas.

In many instances American exporters must offer lease packages which can compete with both the direct financing subsidies offered by host governments and the indirect subsidies available through their more accelerated depreciation allowances, investment grants and tax credits.

B. The effect of the proposed legislation on aircraft and computer manufacturers

In the computer leasing industry, "the largest outlet for capital assets in the world,"[2] and in the aircraft industry, which usually accounts for the United States' single largest export figures annually,[3] there is ample evidence of the steady encroachment of foreign manufacturers into markets which until recently had been the exclusive domains of IBM, Boeing and McDonnell Douglas. In both industries American products are in most cases superior and manufacturing costs are competitive. The only advantage that the newcomers have is the ability to pass along substantial fiscal incentives provided by their host governments.

The most significant of those for the aircraft industry are the foreign export subsidies offered by the European national credit agencies, France's Coface, Germany's Hermes, and Britain's Export Credits Guarantee Department. Airbus Industrie's assault on Boeing is a case in point. According to the authors of the "Civil Aviation Survey" appearing in the May 28, 1983, issue of the Economist:

"Until recently nobody worried: Boeing had such a stranglehold over the world market that the efforts of the European agencies were futile. . . .

"But in the late 1970s the balance of sales began to swing against Boeing, and Boeing began to accuse the Europeans of benefiting from unfair subsidies and political interventions. Boeing lost important sales to Airbus in the Middle East and Far East—areas where air transport is growing much faster than in America or Europe, which are now mature markets. In 1976 Airbus had just 3 percent of the market for widebody airliners. Then it began growing: 19 percent in 1977; 23 percent in 1978; 38 percent in 1979; 32 percen in 1980;[4] and 55 percent in 1981."—Civil Aviation Survey," supra note 3, at 18.

While the United States Export-Import Bank assists both Boeing and other United States aircraft manufacturers, its subsidies have been extremely limited and inconsistent, due largely to political and budgetary considerations. Fleming, "International Leasing Grows in Popularity," Business America, November 1, 1982, at 27.

As a result, Airbus has become a credible competitor. Outside of North America more than 65 percent of all widebodies have been ordered from Airbus. Moreover, the segment of this market with the most growth potential, the developing countries, is already clearly dominated by Airbus. Civil Aviation Survey, supra note 3, at 18. Boeing maintains that—

"[A]irlines in the Middle and Far East have broken the Boeing habit *because the Europeans have offered better financing*. Before the common line agreement [between the United States, France, Great Britain and West Germany] in 1981 fixed 12 percent as the minimum interest rate, some Airbus financing had been offered for as little as 7.5 percent, and Boeing argues that a 2 percent financing advantage nullifies a 4-5 percent advantage in fuel consumption."—Id. at 18 (emphasis added).

To the analysts writing for The Economist, "[i]t is inconceivable that the Airbus project would have survived if subjected to truly commercial criteria. The consortium delivered only 57 aircraft in its first five years of deliveries, a schedule which would have bankrupted an American company. Indeed, Boeing accuses Airbus of having received subsidies from its government-owned shareholders of over $5 billion."—Id. at 18.

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[2] Economic Consulting Services Inc., "The International Operations of U.S. Service Industries: Current Data Collection and Analysis, Final Report," at 200 (June 1981).

[3] "Civil Aviation Survey," Vol. 287, No. 7291 Economist 17 (May 28, 1983).

[4] This figure appears to be a typographical error in the original text. The percentage for 1980 should probably read "42 percent".

This is partly because Airbus is structured as a "groupment d'interet economique"—a concept known only to French law. The owner/members who are other government-owned or supported aircraft suppliers act as guarantors of Airbus' commitments and take the risks—and rewards—according to their shares. But the components which the members supply to Airbus are ordered and paid for as though they were outside contractors. This means that the lower their costs, the greater their individual profit margin. Moreover, because of its structure Airbus produces no public accounts and any losses are hidden in its members' annual statements. Id. at 21.

Such supports afforded Airbus its initial penetration of United States airspace when, in 1978 the French-backed manufacturer offered Eastern Airlines the use of 4 of its A300 aircraft on a free six-month trial, and a deferred payment schedule under which 12 of 23 aircraft were to be paid for over a period of four years as though they had only the 170 seats Eastern originally ordered instead of the 250 seats Airbus agreed to deliver. "Airbus has effectively given Eastern an interest-free loan." Id. at 17.

It is this type of foreign government intervention that Boeing and other American manufacturers must be able to continue to combat. By limiting the only available means of offering competitive financing for their exports, the proposed legislation will handicap American manufacturers in their efforts to halt the erosion of their former control of the world market.

In the computer hardware industry United States domination of the marketplace through companies such as IBM is well documented. Yet IBM's position, like that of Boeing in the aerospace industry, is now precarious at best. In the past 13 years, IBM's share of the mainframe computer market has slipped from 70 percent to 62 percent, due in part to the increased presence of both foreign and domestic competitors. N.Y. Times, January 9, 1982, at 37, col. 5.

Until recently foreign business accounted for roughly 50 percent of IBM's total revenues and earnings. Last year, largely because of the strength of the dollar, foreign operations accounted for 48 percent of revenues of $29.1 billion and 37.5 percent of net income of $3.3 billion. N.Y. Times, September 19, 1982, Section 3 at 1, col. 2.

It is anticipated that IBM's largest competitors—the several Japanese computer firms—will continue to increase their market share at IBM's expense. Unlike its Japanese competitors which utilize extensive government financed research, American computer manufacturers must rely heavily on profits to fund their future development programs. Leasing equipment with a greater economic yield than would be available under more typical debt financing arrangements can provide those profits.

According to The New York Times Japan has already secured 50 percent of the newest markets, including the market for the 64K random access memory chip, in part due to over $125 million of subsidies from the Japanese Ministry of International Trade and Industry. N.Y. Times, October 28, 1982, at D1, col. 3; Utal, "Here Comes Computer Inc.," Fortune (October 4, 1982), at 84.

Japan's Ministry of International Trade and Industry, with the cooperation of its six largest computer companies, has arranged for government financing of $100–$200 million a year over the next eight years for the Ministry's recently announced project to develop by the end of the decade a computer with a capacity 100 times greater than that of any currently available. N.Y. Times, October 28, 1982, supra. The Japanese government's backing of this project is at "roughly twice the level of U.S. government spending for similar research." Utal, supra at 82.

IBM recognized the significance to its sales figures of leasing mechanisms with the announcement in 1982 of an unprecendented policy of inviting relationships between its customers and third party leasing companies, thereby admitting to the marketplace users that could not have borne the capital expenditures for new equipment without lease financing. Martin, 13 Leasing Digest 14 (December, 1982).

In his May 25, 1983, letter transmitting to Chairman Rostenkowski his Subcommittee's report regarding Tax and Budget Issues Related to Leasing by Nontaxable Entities, Congressman Rangel, Chairman of the House Ways and Means Subcommittee on Oversight, recommended reexamination of cost recovery deductions and "true lease" analysis to such leasing transactions, identifying the goal "that the tax system . . . not make leasing more attractive to these entities than direct ownership[,]" and finding that the impact such arrangements have on Treasury receipts and, consequently, the Federal deficit, results from situations "in which the nontaxable entity would probably have chosen direct ownership." Subcomm. on Oversight, House Comm. on Ways and Means, 98th Cong. 1st Sess., WMCP: 98-7 at VI-VII (Comm. Print, May 25, 1983).

But, as this submission points out, foreign lessees, for the reasons set forth, are often not likely to choose direct ownership. Rather, such lessees will choose products where the tax benefits of leasing or other direct subsidies for export or capital investment will decrease their costs, preserve their capital and credit, and insulate them from technological obsolescence.

In order to preserve American products as the standard in international commerce, Michael J. Fleming, Executive Director of the American Association of Equipment Lessors, writing in the November 1, 1982, issue of Business America, suggested that "[a] broadening of the eligibility requirements of the ERTA provisions to include new U.S.-manufactured equipment owned by a U.S. lessor but leased overseas would contribute greatly to the goal of increased U.S. productivity in the equipment manufacturing sector of our economy." Fleming, supra at 28.

It is vital that existing capital recovery methods remain an important tool in preserving our export advantage, since according to USITC sources "a greater share of U.S. merchandise is expected to be exported as a direct result of United States international leasing activities." United States International Trade Commission, supra at 143.

C. The effect of American foreign leasing activities on the balance of payments

The proposed restrictions on deductions for depreciation of capital assets leased overseas will be most detrimental to the United States balance of payments. According to an independent survey prepared for the Departments of Commerce and State in 1981 by Economic Consulting Services Inc. ("ECS"), there is overwhelming evidence that the international operations of United States service industries, including leasing companies and banks, have been a major contributive factor in maintaining a surplus in the balance of payments during a period when American manufacturers are experiencing some of the most significant trade deficits of recent years. Economic Consulting Services Inc., supra note 2, at 7. (Domestic and international revenues from equipment leasing services accounted for approximately 7.5 percent of the total United States service trade surveyed in 1981). United States International Trade Commission, supra at 146.

The international trade balance in equipment leasing services heavily favors the United States—according to the USITC by over $10 billion—due to the negligible presence of foreign lessors operating in the United States. *Id.* at 145. Between 1970 and 1980 the United States balance on merchandise trade dropped from a $2.6 billion surplus to a $27.5 billion dollar deficit. After factoring into the 1980 figures the net balance of payments and receivables from private service transactions, however, merchandise deficits were offset to the extent of a $7.1 billion surplus on balance of goods and services. Economic Consulting Services Inc., supra at 7–9.

American leasing firms have traditionally enjoyed a dominant position in the volume of leased asset transactions worldwide, but there is considerable evidence that as the industrialized nations shift from products-oriented to service-oriented economies there will continue to be significant shifts in market shares. Id. at 13. Specifically, the growth of leasing activities by some non-United States firms appears to be proceeding to a greater rate than their domestic counterparts. See E.g. Introduction, World Leasing Yearbook 1983 at 6, 249. Accordingly, ECS has reported to the Department of Commerce that the elimination of impediments to the international exchange of services should be a major task of all commercial policy formulation, and of particular importance to the United States "if its international economic position as an evolving service economy is to be strengthened." Economic Consulting Services Inc., supra note 2, at pp. 13–14.

Beyond leasing service revenues, international leasing activities augment the net trade balance annually since, according to industry spokesmen, all American manufactured aircraft delivered abroad (which account for our single largest export totals) are subject to lease financing arrangements of one type or another, and the computer leasing industry is the world's greatest outlet for capital expenditure. See p. 19 supra.

While there are no isolated figures which indicate the extent to which particular leasing activities contribute to balance of payment totals, ECS estimated that there were 1800 specialized financial institutions and subsidiaries of industrial corporations engaged significantly in general equipment leasing, and relied on projections of the American Association of Equipment Lessor's that its members generated some $10 billion in outstanding receivables from international leasing activities. Economic Consulting Services Inc., supra note 2, at 197, 199.

The growth of international equipment leasing as a preferred financing vehicle instead of as a method of last resort for cash-strapped industries, and its enormous profitability for domestic taxpayers, is revealed in the commitment made by the United States' largest multinational financial institutions.

Most international lease operations—even those for which foreign export finance subsidies are avaialble—are funded to a substantial extent by domestic lending sources. See, E.g. Brannen, Subsidized Export Financing, World Leasing Yearbook 1983, at 43. This generates not only additional finance revenue, but affords American banking interests a powerful foothold in financial communities around the world, increasing the United States' sphere of influence politically as well as economically.

Our major financial institutions can expect to experience erosion of their capital bases if there is any substantial decrease in the flow of funds generated from international equipment leasing.

Among the factors listed by Karl M. Parrish, Chairman and Chief Executive Officer, Manufacturers Hanover Leasing Corporation ("MHLC"), in analyzing his parent bank holding company's move into this highly profitable nonbanking sector, he cited the following:

"Counter-Cyclical Earnings: The earnings flow of a conventional leasing subsidiary moves in inverse proportion to commercial banking activities. Because leases are made at fixed rates, they continue to provide high interest rate income streams when rates are tending to go down but, conversely, provide low interest rate streams of income when rates are tending to go upward."—Parrish, "Non-Bank Subsidiaries Are Wise Bank Investment . . .," American Banker, February 10, 1982, at 19.

(MHLC is apparently the largest bank-affiliated leasing company in the world, with 19 United States and 25 overseas offices). Id. at 21.

It is estimated that almost two-thirds of the future earnings potential at Manufacturers Hanover Corporation could relate to its international and domestic leasing activities. The reported residual value of MHLC's leasing portfolio (i.e., what the assets are worth when they come off lease) is expected to add up to $550 million to its holding company's earnings before 1990. Carson, "Banking Companies' Leasing Subsidiaries Add Big Bucks; Many Leasing Companies Are Twice As Profitable As Their Parent Banks," American Banker, June 17, 1981, at 1.

Citicorp, which is believed to be the second largest owner of commercial aircraft in the world, is estimated to have some $1 billion in unrecognized residual value. Id. Residual value, however, is not the only reason that their leasing activities are more profitable for such banks on the whole.

The sheer volume of banking business generated, even during periods when inflated interest rates make typical lending impossible, has stimulated capital growth.

"Bank leasing has grown wildly in the last ten years. In many cases volume has increased more than twice as fast as the banks' business loans. At Chemical New York Corp., average domestic business loans grew about 1.3 times from 1976 to 1980, while average leasing receivables grew 3.8 times.—"Id.

These statements demonstrate the importance of the equipment leasing industry to the major United States financial institutions, and the commitment made by such institutions to leasing's rapid emergence and a significant profit center, as opposed to more traditional methods of bank finance. The USITC September 1982 report on "The Relationship of Exports in Selected U.S. Service Industries to U.S. Merchandise Exports" indicates that the expectations that United States international leasing activities would enhance export opportunities are correct, and that a greater share of United States merchandise is expected to be exported as a direct result of United States international leasing activities. See p. 27, supra. As the venue of leaseable merchandise shifts more visibly offshore, doubtless United States debt and equity sources will follow. But that international presence can only be nurtured in an atmosphere that permits reasonable investment opportunities overseas. The limitations of the proposed legislation will effectively extinguish those opportunities and, in the resulting retrenchment, deplete the available capital base for further investment at home.

Profitability through leasing is a business concern of others than the debt or equity sources in international transactions. The ability to lease equipment increases the (taxable) profits domestic manufacturers can realize by taking into account the uses to which leased assets will be put after an initial lease term. Any retained residual earnings from further leases by American taxpaying lessor/manufacturers of lessor/financing sources will generate revenue and expand the market for domestic goods and services.

Secondly, the greatest demand for advanced developments in computer and aerospace technology, for example, is in the United States and a few other major industrialized nations. Because of this, a unique relationship has been created with other foreign nations requiring less modern equipment and, as a result, American suppliers can expect to export used equipment and replace it with new leased equipment. United States Dept. of Commerce, supra at 53; Economic Consulting Services Inc., supra note 2, at 205. The availability of realistically calculated asset recovery periods under existing ADR guidelines for property used outside of the United States permits American manufacturers and financing sources to include in their capitalization the exploitation of secondary and later markets for used equipment, developing at the same time new markets for replaced and replacement equipment. Both of these considerations directly support United States export policy.

While Congressman Rangel's statement indicates that direct ownership is the logical extension of discouraging leasing to nontaxable entities (See pp. 25–26, supra), such an analysis would not account for the fact that there are non-financial factors in the decision to lease equipment abroad.

As a practical matter, lease financings enhance the opportunities for secure investment of American capital overseas, where ownership of the financed asset helps to insulate the investor from much local political and economic turbulence. "The separation of use and ownership in areas of high political risk can be an important factor for multinational companies." Clark, "The Dawn of International Leasing," The Banker (April , 1982) at 59.

"Ownership of equipment affords a leasing company better security than a mortgage or charge held by a bank. In many countries enforcement of a mortgage is fraught with legal obstacles and procedural difficulties, so that leasing companies are in a position to enjoy preferential treatment in the event of default by an equipment user. The high cost of executing and registering equipment mortgages can also be avoided by leasing."—Id. at 61.

The proposed legislation, to the extent it effectively removes such protections, runs in direct opposition to foreign policy and budgetary concerns to foster relations with both developing and industrialized nations through the private sector.

The impact of H.R. 3110 on the American economy, as demonstrated, is far greater than its authors anticipated.

Existing law has maintained a climate in which United States manufacturers can hope to survive the onslaught of foreign government subsidies in support of competing products.

The American leasing industry's international activities make a major contribution to the health of our export market. The stability of that market is vital to our labor force and international trade balance.

It is essential that Congress thoroughly consider the economic realities before taking action on the bill, and we urge the adoption of the alternatives discussed above to reverse the chilling effect that the introduction of the bill has had on international commerce.

[Exhibit I]

ALTERNATIVE A

SECTION 1. DENIAL OF TAX INCENTIVES FOR PROPERTY USED BY GOVERNMENTS AND OTHER TAX-EXEMPT ENTITIES

(a) GENERAL RULE.—Subparagraphs (2)(A) and (B) of Subsection (f) of section 168 of the Internal Revenue Code of 1954 (relating to special rules for application of accelerated cost recovery system) are amended to read as follows:

"*(2) Recovery property used predominately outside the United States and by governments and other tax-exempt entities.—*

(A) IN GENERAL.—Except as provided in subparagraphs (B) and (C), in the case of recovery property which, during the taxable year, is used predominately outside the United States or by a tax-exempt entity, the recovery deduction for the taxable year shall be, in lieu of the amount determined under subsection (b), the amount determined by applying to the unadjusted basis of such property the applicable percentage determined under tables prescribed by the Secretary. For purposes of the preceding sentence, in prescribing such tables, the Secretary shall—

"(i) assign the property described in this subparagraph to classes in accordance with the present class life (or 12 years in the case of personal property with no present class life) of such property; and "(ii) assign percentage (taking into account the half-year convention) determined in accordance with use of the methods of depreciation described in section 167(b)(2), switching to the method described in section 167(b)(1) at a time to maximize the deduction allowable under subsection (a).

"(B) Real property.—

"(i) In general.—Except as provided in subparagraph (C), in the case of 15-year real property which, during the taxable year, is predominantly used the United States or by a tax-exempt entity, the recovery deduction for the taxable year shall be, in lieu of the amount determined under subsection (b), the amount determined by applying to the unadjusted basis of such property the applicable percentage determined under tables prescribed by the Secretary. For purposes of the preceding sentence in prescribing such tables, the Secretary shall—

"(I) assign to the property described in this subparagraph a 35 recovery period; and

"(II) assign percentage (taking into account the last sentence of (b)(2)(A) determined in accordance with use of the method of depreciation described in section 167(j)(1)(B), switching to the method described in section 167(b)(1) at a time to maximize the deduction allowable under subsection (a).

"(ii) Special rule for disposition.—In the case of a disposition of 15-year real property described in clause (i), subsection (b)(2)(B) shall apply."

* * * * * * *

(b) Definition of tax-exempt entity.—Subsection (f)(2) of section 168 of the Internal Revenue Code is amended by redesignating subparagraph (E) as subparagraph (G) and by inserting after subparagraph (D) the following new paragraphs:

"(E) Tax-exempt entity.—For purposes of this paragraph, the term "tax-exempt entity" means—

"(i) the United States, any State or political subdivision thereof, any possession of the United States, any foreign government, any international organization, or any agency or instrumentality of any of the foregoing,

"(ii) an organization (other than a cooperative described in section 521) which is exempt from tax imposed by this chapter, and

"(iii) any person who is not a United States person (but only with respect to property the income derived from the use of which is not subject to tax under this chapter)."

"(F) Treatment of certain contracts for providing services.—For purposes of this paragraph and paragraphs (4) and (5) of Section 48(a), a contract which purports to be a service contract shall not be treated as a service contract if such contract is more properly treated as a lease of property (taking into account all relevent factors including whether or not such entity controls the property or such entity has a significant possessory or economic interest in the property."

[Paragraphs E and F quote section 168(f)(13)(D) and (E) as proposed by H.R. 3110].

Alternative B

[Addition to Code section 168(f)(13) as proposed in H.R. 3110]

(a) General Rule.—

* * *

(b) Operating Rules.—

* * *

"(v) Coordination with paragraph (2).—
This paragraph shall not apply to any property to which paragraph (2) applies."

[Exhibit II]

COMPARISON OF COST RECOVERY SYSTEMS BUS: 9-YEAR USEFUL LIFE

[In percent]

	Domestic ADR (prior law)	Present domestic ACRS	Proposed H.R. 3110	168(f)(2) [1] (present law for most foreign assets) and alternative A or B herein
ITC	10.0	10.0	0.0	0.0
Year:				
1	14.3	15.0	4.25	11.1
2	24.2	22.0	8.5	19.8
3	17.5	21.0	8.5	15.4
4	12.5	21.0	8.5	12.0
5	8.9	21.0	8.5	12.0
6	8.9		8.5	7.2
7	8.9		8.5	7.2
8	4.5		8.5	7.2
9			8.5	7.2
Economic life:				
10			8.5	3.6
11			8.5	
12			8.5	
13			4.25	
14				
Total Deduction [2]	120.0	120.0	100.0	100.0

[1] Present law for most foreign assets.

[2] 10 percent investment tax credit assumed to be equal to 20 percent deduction.

BARRETT SMITH SCHAPIRO SIMON & ARMSTRONG,
New York, N.Y., June 2, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: I wish to express my concern as to the apparent failure of the transitional provisions of H.R. 3110, as introduced, to "grandfather" certain leasing transactions with respect to property that was subject to binding written contracts prior to the bill's proposed effective date of May 23, 1983. As explained below, the transitional rule of H.R. 3110 appears to omit protections normally afforded by the Congress to persons who have entered into binding commitments in reliance on the law which was in effect when their contracts were executed, and for which no legislative changes had been proposed. I urge that the transitional rules be expanded to provide customary protection to persons who made binding commitments in reliance on the present leasing provisions prior to the introduction of H.R. 3110. Draft statutory amendments to achieve this result accompany my letter.

Background: I am at present representing a lessee—a foreign airline—negotiating the final terms of U.S. leveraged lease transactions for two U.S.-manufactured commercial aircraft scheduled for delivery this month. Prior to the introduction of H.R. 3110 on May 24, (1) a binding purchase contract for the two planes had been in effect for over a year; (2) the major terms of both lease transactions had been settled with equity investors; (3) voluminous documentation had been drafted, circulated and revised, and was in the process of negotiation; and (4) the airline, as well as the equity investors, had incurred substantial transaction costs, which have continued to mount and which may ultimately be for naught unless the transition rules apply to these transactions. Moreover, the airline, relying reasonably on the U.S. tax law in effect, has sacrificed other potentially advantageous financing arrangements to engage in the lease financings with the U.S. equity investors.

Although the purchase contract for the two aircraft has long been binding and the lease documentation was almost completed by May 23, as is typical in lease transactions, a binding commitment to lease was not executed by that date. If H.R. 3110 is enacted as introduced, so that transactions of the type described above are not "grandfathered," the airline will have to look for alternative financing. Even if alternative financing is found, in light of the severe time constraints caused by the imminent delivery of the aircraft, the terms of any such alternative financing are likely to be less favorable than could normally be obtained. Moreover, the airline will bear the double expense of negotiating the alternative arrangement.

Analysis: As drafted, the binding contract rule of H.R. 3110 does not appear to exempt the type of leasing transactions described above—notwithstanding the existence of a binding contract for the acquisition of the aircraft—because there was not also in existence by May 23 a binding contract for the airline to lease the aircraft (Bill Section 1(d)(2)(B)). The bill's double-commitment requirement would unfairly imperil many typical transactions. Any substantive changes in the taxation of leasing activities should "grandfather" all lease transactions of equipment acquired pursuant to binding purchase agreements in effect on May 23, 1983, where the lessee is the party that was bound to acquire the equipment under the purchase agreement. See, *e.g.*, Section 49(b)(5) of the Code. It is well recognized that the availability of leasing under existing tax law serves to induce persons who cannot take advantage of capital formation tax incentives directly to make purchase commitments for equipment. Thus, for example, when the safe harbor leasing provisions were substantially changed by TEFRA, transitional rules were provided which looked to the lessee's commitment to acquire or construct the property and not to the existence of a contract to lease. (See Tax Equity and Fiscal Responsibility Act of 1982, Section 208(d)(2)–(6).)

Proposal: All equipment subject to binding purchase commitments as of May 23, 1983, should be "grandfathered." However, if Congress decides not to "grandfather" all equipment subject to binding purchase commitments as of May 23, 1983, it should as a minimum allow leasing transactions that have reached significant levels of planning—such as the two aircraft transactions described above—to go forward under present law. As described above, these cases already involve substantial costs and other financial commitments. If forced to abort the planned leasing transactions at this stage, the lessees will be seriously injured. These lessees can be protected through the incorporation of a reasonable outside date for placing the equipment in service under a lease. A reasonable "placed-in-service" date might be December 31, 1983.

Alternative drafts of amended transitional rules are enclosed. Alternative A would grandfather equipment that was under a binding purchase agreement with a tax-exempt entity as of May 23, 1983 if it is leased to the tax-exempt entity. Alternative B would limit such grandfathered benefits to property placed in service by the lessor prior to January 1, 1984.

Respectfully submitted.

RICHARD M. LEDER.

ALTERNATIVE A

(d) EFFECTIVE DATES.—

* * * * * * *

(2) BINDING CONTRACTS.—The amendments made by this section shall not apply with respect to any property used by a tax-exempt entity (as defined in section 168(f)(13)(D)) if—

(A) such use is pursuant to one or more written binding contracts which on May 23, 1983, and at all times thereafter, required—

(i) the taxpayer (or his predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate such property, and

(ii) the tax-exempt entity (or a related entity) to use such property, or

(B) a binding contract for the tax-exempt entity (or a related entity or a successor in interest under the contract of such tax-exempt or related entity) to acquire, construct, reconstruct or rehabilitate such property was in effect on May 23, 1983.

In the case of any property used by the United States or an agency or instrumentality thereof, paragraph (A) shall apply only if such property is placed in service by the taxpayer before January 1, 1984.

ALTERNATIVE B

(d) EFFECTIVE DATES.—

* * * * * * *

(2) BINDING CONTRACTS.—The amendments made by this section shall not apply with respect to any property used by a tax-exempt entity (as defined in section 168(f)(13)(D)) if—

(A) such use is pursuant to one or more written binding contracts which on May 23, 1983, and at all times thereafter, required—

(i) the taxpayer (or his predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate such property, and

(ii) the tax-exempt entity (or a related entity) to use such property, or

(B) a binding contract for the tax-exempt entity (or a related entity or a successor in interest under the contract of such tax-exempt or related entity) to acquire, construct, reconstruct or rehabilitate such property was in effect on May 23, 1983.

In the case of any property used by the United States or an agency or instrumentality thereof, paragraph (A) shall apply only if such property is placed in service by the taxpayer before January 1, 1984. Paragraph (B) shall apply only if such property is placed in service by the taxpayer before January 1, 1984.

BARRETT SMITH SCHAPIRO SIMON & ARMSTRONG
Washington, D.C., June 22, 1983.

MEMORANDUM: EVIDENCE OF RELIANCE IN FOREIGN AIRCRAFT LEASING TRANSACTION

H.R. 3110, as introduced, will adversely affect certain foreign aircraft lease transactions which were substantially completed on the date of introduction but which are not grandfathered by the bill's effective date provision. In the case of two Boeing 747-300's leased by Singapore Airlines, a binding sales contract had been signed, necessary Federal Aviation Administration ("FAA") approval obtained, and the lease documentation substantially completed but not executed, as of May 23, 1983. One of these airplanes has been delivered and its lease was signed on June 21, 1983; the second will be delivered within 10 days. Both transactions were structured in reliance on the present tax law. Unless the grandfather rule of H.R. 3110 is modified to recognize such reliance, both lessor and lessee will be adversely affected.

Strong evidence of substantial economic commitment to a lease and reliance on the present tax law are available from foreign airlines' pre-operation filings required by the FAA, the Federal Register publication of such filings, and FAA decisions on them. Foreign airlines planning to operate leased aircraft in the United States must file for FAA approval at least 120 days prior to the start of operations. Four months before the delivery date for Singapore Airlines' 747's, the airline filed the necessary applications, specifying both airplanes by serial number. The FAA approved the application on May 20, 1983. A copy of the FAA decision ("Grant of Exemption") is attached. Such filings entail substantial legal costs—at least $20,000 to $30,000. Moreover, the FAA procedings and inspections involve a significant number of staff hours. Thus, airlines file such applications only when a firm decision has been made to enter into a leasing arrangement.

The effective date for H.R. 3110 should be amended to "grandfather" transactions involving binding commitments undertaken in good faith reliance on the present tax rules. Reference to FAA proceedings in the case of foreign airline leases may help determine justified transitional relief without unduly relaxing the effective date and benefitting deals which did not involve genuine commitments and reliance at the time that H.R. 3110 was introduced.

Because of the substantial preparation which must precede FAA filings, the lead-time for an airplane lease transaction is clearly longer than four months. In view of the length of the necessary lead-time, most, if not all, airplanes to be placed in service in 1983, almost certainly were the object of substantial economic commitments by May 23, 1983. Thus, if a foreign airline had a binding contract to purchase an airplane on May 23, 1983, it would be appropriate to grandfather the airline's aircraft leases, provided the airplanes are placed in service by December 31, 1983.

RICHARD M. LEDER, Esq.
WILLIAM C. CLARKE, Esq.
MICHELLE P. SCOTT, Esq.

[Exemption No. 3768]

UNITED STATES OF AMERICA,
DEPARTMENT OF TRANSPORTATION,
FEDERAL AVIATION ADMINISTRATION,
Washington, D.C.

In the matter of the petition of Singapore Airlines for an exemption for § 21.181 of the Federal Aviation Regulations.—Regulatory Docket No. 23521

GRANT OF EXEMPTION

By letters dated February 4, and April 28, 1983, William C. Clarke, Esquire and Joanne W. Young, Esquire with Barrett, Smith, Schapiro, Simon and Armstrong, 1201 Pennsylvania Avenue, N.W., Washington, D.C., petitioned on behalf of Singapore Airlines (SIA), for an exemption from § 21.181 of the Federal Aviation Regulations (FAR) to operate two leased, U.S.-registered Boeing 747-300 Stretched Upper Deck (SUD) aircraft, Serial Nos. 23027 and 23028, utilizing a Federal Aviation Administration (FAA)-approved minimum equipment list (MEL).

Section of the FAR affected:

SIA's operation is governed by the following regulation which does not permit the use of an MEL.

Section 21.181, which provides, in pertinent part, that an airworthiness certificate is effective so long as the maintenance, preventive maintenance, and inspections are performed in accordance with Parts 43 and 91.

"This provision prohibits the operation of an airplane with either inoperable items of installed equipment or missing items of required equipment. With respect to equipment required under an aircraft type certificate, the supplemental type certification procedures of Part 21 provide a means to change the type certificate to permit operations with inoperable or missing equipment. Since SIA is not a Part 121 certificated air carrier, it is not required to meet the additional equipment requirements of Part 121 and is, therefore, not authorized to use the MEL. However, operations by SIA with equipment required by Part 121 installed, but inoperable, would be prohibited under Part 91."

The pertinent information provided by petitioner is as follows:

SIA is a foreign air carrier which holds operations specifications under Part 129 of the FAR. The aircraft will be purchased new by U.S. financial institutions, under assignment of the present SIA purchase contract with Boeing Commercial Airplane Company. Simultaneously, the financial institutions, acting as trustee and lessor, will lease the aircraft to SIA pursuant to net lease agreements for 12 to 15 years. Copies of the lease will be provided to the FAA as soon as the lease is executed. The owner will apply for U.S. registration of the aircraft in due time, related to the scheduled delivery dates in June 1983. The aircraft will be operated on international flights by airmen currently employed by SIA who possess the requisite airman certificates issued by the Republic of Singapore Civil Aviation Authority (CAA) and who will possess properly issued FAA airman certificates.

SIA understands that the effectiveness of its exemption authority will be conditioned on its application for, and the issuance of, special-purpose airman certificates pursuant to §§ 61.77 and 63.23 of the FAR.

Under the terms of the lease, SIA will be required to maintain the aircraft in accordance with all FAA requirements and in compliance with all applicable laws and regulations. Furthermore, under the lease terms the maintenance standards cannot be below those applied to similar aircraft owned or leased by SIA.

SIA currently utilizes, with minor changes, the Boeing-recommended continuous airworthiness maintenance program for its B-747 fleet. This program is the same as those U.S. air carriers are authorized to utilize under Part 121. SIA will submit its B-747 maintenance program to the FAA under Part 121. SIA will submit its B-747 maintenance program to the FAA Air Carrier District Office in Burlingame, California, for approval.

SIA currently holds U.S. Foreign Repair Station Certificate No. 661-34F (issued November 29, 1982), for its Singapore maintenance base. The application was processed by the FAA's Honolulu office, and the Operations Specifications of the certificate carry the necessary overall ratings. At all U.S. line stations, SIA contracts out B-747 maintenance work to air carriers holding U.S. Repair Station or Foreign Repair Station Certificates who will perform all maintenance on the aircraft in accordance with the SIA maintenance program approved by the FAA Air Carrier District Office in Burlingame, California.

At the Honolulu line station, Canadian Pacific Air performs SIA's maintenance work; while at Los Angeles, Trans World Airlines performs the maintenance for SIA's operations. At the San Francisco line station, maintenance work is performed by Quantas Airways and Servair of California. All such maintenance is performed under the direct supervision of a resident SIA maintenance supervisor authorized under § 43.3 to perform maintenance, preventive maintenance, rebuilding, and alterations, and § 43.7 to approve the aircraft for return to service. While the aircraft will be predominately operated between Singapore and the above-referenced U.S. destinations, in the event the aircraft does go to other stations, SIA states that line maintenance will be done in accordance with the SIA maintenance program approved by the FAA Air Carrier District Office in Burlingame, California.

"SIA's use of an FAA-approved continuous airworthiness maintenance program is necessary to facilitate international leasing of U.S.-registered aircraft, and will promote safety and efficiency in air transportation.

"The operational requirements of the Republic of Singapore CAA, under which SIA operates its present B-747 fleet, are similar, if not identical, to the requirements for U.S. air carriers under Part 121. Considering this similarity and the fact that SIA will be responsible under the lease for maintaining and operating the aircraft in an airworthy condition under FAA standards, SIA respectfully requests exemption from the procedural requirements of Part 21 to enable it to obtain, by means of the exemption, a supplemental-type certificate covering the operation of the aircraft using the SIA B-747 MEL approved for use by SIA. The SIA MEL is substantially in accordance with the FAA-approved master minimum equipment list (MMEL) for the B-747.

"An exemption enabling SIA to operate the leased aircraft using the FAA-approved MEL is necessary to avoid an undue burden on SIA with respect to the leased aircraft which would have a detrimental effect on international leasing of U.S.-registered aircraft. The exemption will also promote safety by ensuring common operational and technical standards for SIA's 747 fleet.

"SIA states it would like to perform preflight inspections and minor maintenance (line maintenance) at outlying stations located outside the United States, using its own personnel specified in its Foreign Repair Station Certificate (No. 661-34F, issued November 29, 1982). This is permitted under §§ 145.77 and 145.51(d).

"SIA states it needs the flexibility of sending mechanical personnel to perform or supervise routine inspection and line maintenance at stations in 36 cities served by SIA. Work would be performed under the authority of its Singapore maintenance base, a certificated Foreign Repair Station. The operations specifications of this certificated Foreign Repair Station. The operations specifications of this certificate carry the necessary overall ratings. Work would be performed entirely by personnel of other carriers under the supervision of SIA personnel.

"SIA states it will insure that the requirements of §§ 145.77 and 145.51(d) are fulfilled. All work will be performed and aircraft returned to service in accordance with SIA's continuous airworthiness maintenance and inspection program and the operations specifications of the Foreign Repair Station Certificate. SIA will further insure that all work performed at its outlying stations will conform to the same high standards of safety and quality control as are followed at the maintenance base in Singapore. All work will be performed by personnel assigned to the main base, or having the same high qualifications, and who will hold all appropriate mechanics licenses issued by the Republic of Singapore.

"SIA states that the FAA recently approved a similar proposal for Japan Air Lines (Exemption No. 3664, December 1, 1982). SIA has been in contact with the FAA office in Honolulu, and understands that office will work out the appropriate modifications to SIA's Foreign Repair Station Certificate operations specifications, when notified of the approval of FAA's action on the company's petition.

"SIA understands that while an exemption from the provisions of § 61.77 and § 63.23 is not necessary to operate the leased aircraft, the effectiveness of the exemption authority applied for herein will be expressly conditioned on the issuance of special purpose airman certificates under the procedures set forth in those sections. To this end SIA pilots and flight engineers will submit applications for the special purpose certificates through the FAA's Air Carrier District Office in Burlingame, California, on the basis of airman certification standards of the CAA which meet or exceed the International Civil Aviation Organization's (ICAO) standards in all respects. SIA understands that compliance with ICAO standards is a prerequisite to the mutual obligation to recognize certificates of competency and licenses issued by the parties to the Air Transport Agreement between the Republic of Singapore and the United States.

"SIA hereby assures the FAA that it will obtain physical possession of the special purpose airman certificates to be issued under § 61.77 or § 63.23 from SIA flight crewmembers who hold the certificates upon (a) termination of the lease agreement; (b) suspension, revocation, or invalidity of their foreign pilot certificate or license or their medical documentation; (c) the date on which a holder of a pilot certificate reaches the age of 60; or (d) termination of their employment as airmen by SIA for any reason.

"The exemption requested in this petition will enable SIA to continue the commonality and standardization of its fleet and will promote the safety of its systemwide operations to an equal or greater extent than the rules from which an exemption is sought. Moreover, and as the FAA previously determined in Exemption No. 3044, petition of the Department of International Affairs of the General Administration of Civil Aviation of China and Pan American World Airways, Inc., (Docket No. 20779), the granting of the exemption will be in the public interest by facilitating international leasing of U.S.-registered aircraft which expands the utility of such aircraft, promotes trade, helps to stabilize the balance of payments, and otherwise improves the foreign relations of the United States.

A summary of this petition was published in the Federal Register on March 3, 1983 (48 FR 9118). No comments were received.

The FAA's analysis/summary is as follows:

"The FAA has determined that the operation of the Boeing 747-300 (SUD) aircraft, Serial Nos. 23027 and 23028, by SIA under an FAA-approved MEL for those aircraft in conjunction with an FAA-approved maintenance and inspection program will provide a level of safety equal to that provided by the rules from which an exemption is sought.

"The FAA has further determined that a grant of exemption is in the public interest because the leasing of U.S. aircraft improves relations with foreign governments, develops trade, and helps stabilize the balance of payments in favor of the United States.

In consideration of the foregoing, I find that a grant of exemption is in the public interest. Therefore, pursuant to the authority contained in Sections 313(a) and 601(c) of the Federal Aviation Act of 1958 (the Act), delegated to me by the Administrator (14 CFR 11.53), and Section 603 of the Act, Singapore Airlines is granted an exemption with respect to the Boeing 747-300 (SUD) aircraft, Serial Nos. 23027 and 23028, as follows:

"From the procedural requirements of Part 21 of the FAR to the extent necessary to permit SIA to obtain a supplemental type certificate covering the operation of Boeing 747-300 (SUD) aircraft, Serial Nos. 23027 and 23028, in accordance with an FAA-approved MEL for the aircraft. This exemption, together with an FAA-approved MEL, constitutes a supplemental type certificate for the aircraft for the duration of the exemption subject to the following conditions and limitations:

"1. The use of the maintenance and inspection program and the airline MEL, based on the B-747 MMEL, must be submitted to the FAA Air Carrier District Office, Burlingame, California, for approval by the FAA. The petitioner must obtain from that office, prior to commencing operations under its MEL, a letter of authorization for operation of the aircraft using an FAA-approved MEL. All maintenance must be performed by persons authorized in accordance with § 43.3, and the aircraft must be approved for return to service by persons authorized by § 43.7.

"2. A copy of the approved MEL for each aircraft, as appropriate, a copy of this exemption, and a copy of the letter of authorization for operation of the aircraft using the FAA-approved MEL must be inserted into the airplane flight manual of each airplane and carried in the airplane while it is being operated. These documents shall be presented to representatives of the Administrator for inspection upon the request of such representatives.

"3. The maintenance of the U.S.-registered B0747-300 (SUD) aircraft, operating through line stations on the SIA route structure outside the United States, shall be conducted in accordance with the limitations outlined in the SIA Repair Station Operations Specifications, FAA Form 8000-4-1, as amended.

"4. SIA must comply with the requirements applicable to the holder of a supplemental type certificate as contained in Part 21 of the FAR, including the failure, malfunction, and defect reporting requirements of § 21.3.

"5. Each flight crewmember operating under this exemption shall possess either an appropriate U.S. airman certificate or a special purpose U.S. airman certificate with pertinent ratings, issued under § 61.77 or § 63.23 of the FAR, whenever performing flight crewmember duties on the aircraft. A copy of this exemption and a valid U.S. airman certificate shall be presented to representatives of the Administrator for inspection upon request."

This exemption terminates on May 31, 1985, unless sooner superseded or rescinded, or upon expiration of either lease agreement with respect to Boeing 747-300 (SUD) aircraft, Serial Nos. 23027 and 23028, whichever occurs first.

KENNETH S. HUNT,
Director of Flight Operations.

Issued in Washington, D.C., on May 20, 1983.

STATEMENT OF KEVIN H. WHITE, MAYOR, CITY OF BOSTON

The City of Boston and particularly its agencies engaged in economic development and urban revitalization activities are deeply concerned with the amendments of the federal Internal Revenue Code (the "Code") proposed by H.R. 3110. The amendments of Sections 168 and 48 of the Code proposed by the bill could have a devastating impact of these activities. Moreover, if passed, the bill would take effect retroactively, cutting off projects already in the planning stages, some near completion, on which the City has expended substantial efforts, time and money.

There are now in process several development projects critical to the City of Boston These include complex large-scale development projects of the City's public agencies—the Economic Development and Industrial Corporation of Boston ("EDIC/Boston") and the Boston Redevelopment Authority ("BRA")—as well as City-endorsed development projects of the private sector. We doubt that the intended purpose of H.R. 3110 is to hinder the efforts of public agencies to redevelop underutilized inner city properties for use by job-creating industrial or commercial firms. H.R. 3110 in its current form, however, would have a substantial negative impact on such efforts.

We do not oppose H.R. 3110 in its entirety, but we do request modifications which would limit the bill to what we understand to be its true target—the area of sales and leasebacks of property actually used by governmental agencies and other tax-exempt organizations in their customary governmental and tax-exempt activities. Economic development projects should not be affected by H.R. 3110.

Before suggesting for your consideration specific modifications of H.R. 3110, I would like to describe three specific projects as examples of the potential negative impacts of H.R. 3110.

THE BOSTON ARMY BASE

EDIC/Boston has been working for nearly two years on acquisition and rehabilitation plans or the 1.6 million square foot Boston Army Base ("BAB") Building 114 and several smaller associated buildings. EDIC/Boston plans to close on the $15 million in financing for acquisition and Phase I rehabilitation by mid-July, 1983. The financing includes industrial development bonds, a loan of proceeds of an Urban Development Action Grant ("UDAG"), and a Section 108 loan from the Department of Housing and Urban Development ("HUD"). In addition, in order to raise equity to provide leverage required by the terms of both the industrial development bond and the UDAG loan, EDIC/Boston will lease the property to a private entity, which will sublease it to a number of industrial users. Note that governmental grants and loans are not sufficient to finance these projects, and in most cases governmental grants by their terms require complimentary private investment. EDIC/Boston will manage the property and oversee the subleases to industrial firms. An estimated 1500 jobs will be accommodated in the 825,000 S.F. of the Phase I rehabilitation, and 1500 more when Phase II rehabilitation is undertaken in two or three years.

The BAB financing is a true real estate development transaction, with the investments of all parties at risk. It is not a sham to bring dollars into the pockets of EDIC of the City; EDIC/Boston stands at risk of considerable losses and the City is sharing in the risk by foregoing property tax payments for two years in order to help the project meet its debt service.

Moreover, the BAB project is only one of a number of industrial rehabilitation projects currently being undertaken or planned by the City. For example, EDIC has for several years been developing for similar purposes and adjacent property, formerly the South Boston Naval Annex, now known as the Boston Marine Industrial Park ("BMIP"). More than 28 businesses, most of them industrial, have relocated to the BMIP, saving or creating some 1000 jobs in the City of Boston. Several of these businesses have leased existing buildings and undertaken substantial rehabilitation for their particular needs, and in four instances the rehabilitation has been or is being financed with industrial development bonds.

The City of Boston considers the EDIC/Boston, and BMIP, and the other industrial and commercial parks which it has developed and is developing to be critical instruments for relocating industrial employers squeezed out by blight or downtown redevelopment and thus preserving the City's base of blue collar and industrial employment. The rehabilitation of existing structures and its financing on the best available terms are essential aspects of this program.

THE CHARLESTOWN NAVY YARD

Following the departure of the U.S. Navy, the conversion of the abandoned and blighted Charlestown Navy Yard to active re-use has been a long-term project and priority of the City, acting through the BRA. Over $13 million has been invested by the City along with funds granted by the federal Economic Development Administration ("EDA") and HUD to bring the property to a marketable status. Like the BAB and BMIP buildings, the Charlestown former military-use buildings are deteriorated and require substantial rehabilitation for conversion to today's uses. Developers have been attracted to the buildings only on the basis of their pro forma projections which assume the availability of industrial development bond financing in combination with the 25 percent historic rehabilitation tax credit, as well as a 15-year depreciation schedule. The Building No. 36 property has been specifically approved by the BRA in July of 1982 for development and an equity proposal for leveraging an industrial development bond has been in process for some time. The $6.5 million Building No. 36 project has been prepared for official action with respect to industrial development bond financing in June or July of 1983. To retain control of this prime waterfront property, the BRA will remain an owner and lease the building to the private entity.

THE BOYLSTON BUILDING

The Boylston Building is a key development in the City's efforts to change the character of Boston's "Combat Zone" to an area of attractive commericial uses. Currently vacant, the Boylston Building (formerly occupied by pizza parlors, adult book stores, adult entertainment, and peep shows) now has attracted the interest of a developer for use by commercial tentants. When renovated, the building will be instrumental in linking Chinatown to the Theatre District and Downtown shopping areas, and removing the slum and blight which is detrimental to the City's interest of safety and economic health.

The project is supported by the City through the BRA and is sponsored by the Chinese Economic Development Corporation ("CEDC"), a community-based development corporation. As owner, the CEDC will lease the property to a private entity who in turn will lease space to various commercial tenants. The $10.6 million development project involves EDA and HUD UDAG funds, industrial development bond financing, and an equity structure which will leverage the private investment.

The problems posed by H.R. 3110 for these cited projects, as well as many others, are as follows:

(1) None of ECIC/Boston, the BRA, or the CEDC is a "user" of any of these properties in a conventional sense, as they will not occupy the properties. However, the term "user" is inherently vague, and bond counsels have advised that any municipal authority or tax-exempt entity operating a property might be considered a "user" under Section 168(f)(13) of the Code, as proposed by H.R. 3110, solely by virtue of its legal ownership and management of the properties. Such a result would reach far beyond the apparent intent of the bill as indicated by the Committee Report. Under the bill, if ECIC/Boston, the BRA and the CEDC are "users", the costs of these projects could be depreciated by private entities incurring such costs only over 35 years, rather than 15 years. In combination with its proposed amendment of Section 48 of the Code, which would deny the rehabilitation tax credit for all properties using industrial development bond financing, H.R. 3110 would place in jeopardy the financing of the projects described above and investment by private users in many other projects slated to be owned or operated by the public agencies of municipalities, community development corporations or other tax-exempt entities.

The concern that the term "user" be interpreted too broadly is based not only on its inherent vagueness but also on the fact that the same term already has been very broadly interpreted by the Internal Revenue Service ("IRS") in a related context. Section 103(b)(6) of the code limits the capital expenditures of "the principal user" of certain facilities financed by industrial development bonds. The phrase "the principal user" is not defined in the code or in the regulations issued under Section 103. It has been interpreted, however, in private rulings of the IRS to include a person who merely owns a facility and even, in certain instances, to include more than one "principal user" for any given facility. The fear that the term "user" as it appears in the proposed amendment of Section 168(f) will prove unworkable thus derives from the very broad interpretation of the same term by the IRS under Section 103(b)(6).

(2) Similarly, the limitation of the rehabilitation tax credit by H.R. 3110's proposed amendment of Section 48 of the Code should be directed not at all industrial development bond financings, but only those of the nature targeted by the Commit-

tee Report, that is, those in which a tax-exempt entity is an actual user of the property financed. As written, the amendment to Section 48 would affect not only the financing of the above-cited projects, but also all rehabilitation projects financed with industrial development bonds and would deal a severe blow to the efforts of the City to induce private enterprise to refurbish and put to use outmoded and blighted inner city structures.

It should be specifically noted that industrial development bond financing has proven highly valuable in inducing developers of downtown office and commercial space to rehabilitate and preserve existing structures rather than bypass the downtown for suburban development or confine new development to office towers. Substantial equity is required to leverage private financing for these large-scale projects. Industrial development bonds are essential to obtaining affordable financing which in turn translates into rent levels that match the market for inner city structures in depressed areas.

In Boston, as well as in all Massachusetts, industrial development bonds for commercial projects are targeted to Commercial Area Revitalization Districts designated by the City and approved by the Massachusetts Department of Communities and Development, which are economically depressed areas of the City. The Massachusetts Industrial Finance Agency ("MIFA") in 1982 promulgated guidelines limiting the financing of rehabilitation projects for commercial uses with industrial development bonds. The guidelines specify, inter alia, that each project be in "an older established commerical center . . . experiencing commercial disinvestment" and that at least 50 percent of the proceeds of each such industrial development bond financing be applied to costs of rehabilitation, as opposed to mere acquisition. The intent of the guidelines is to assure that these financings are directed at the projects of greatest need and are used in ways that genuinely benefit deterioration urban cities. The City's Boston Industrial Development Financing Authority has endorsed and adopted these guidelines.

(3) H.R. 3110 provides that proposed Section 168(f)(13) will not affect projects for which the taxpayer signed a "binding contract" on or before May 23, 1983, but the bill does not give a definition for "binding contract." In the case of the BAB project, a "best efforts" agreement between EDIC/Boston and the private entity was signed prior to May 23. Given the exceptions and qualifications always present in "best efforts" agreements, and also in similar instruments such as agreements in principle and letters of intent—and given that stronger commitments are not commonplace in complex real estate transactions—it is too demanding of the bill to require a binding contract. Many projects are planned, proceeded with, and relied on without such a commitment. For example, in the case of the BAB project, many of the financing documents and related instruments were drafted prior to May 23, and EDIC/Boston and other parties had incurred hundreds of hours of professional services by that date.

The City has committed resources to a large number of economic development projects with longer planning times which also should not be undermined by retroactive legislation. For example, projections show that industrial development bond financing will be critical for Phase II of the BAB project, for which EDIC will purchase the land and buildings before mid-July 1983, but for which development financing is two or three years away. If EDIC cannot remain involved as an owner or manager, the City will lose control over a principal part of the Boston waterfront. Similarly, the City has expended considerable funds and efforts to bring to fruition the Boylston Building and Charlestown Navy Yard projects and many other projects.

The City's ongoing efforts to restore blighted areas and encourage the preservation and growth of employment in the inner city are critical to its future. The amendments proposed by H.R. 3110, if passed, would deal a severe and lasting blow to these efforts. They inevitably would reduce development and channel what remains away from public control toward private control and away from the rehabilitation of existing structures to their demolition and replacement. To make such a drastic change of law retroactive, as H.R. 3110 proposes, pulls the feet out from under the City.

I urge your consideration of the following areas for modification of H.R. 3110:

(1) Define "user" so as not to apply to public agencies leasing space to private businesses by adding a new subsection (iv) to Section 168(f)(13) as proposed by H.R. 3110, as follows:

"(C)(iv) EXCEPTION FOR MERE OWNERSHIP OR MANAGEMENT.—Mere ownership or retention of legal title to property, or management of property without occupation, by a tax-exempt entity shall not constitute "use" of such property within the meaning of this paragraph.

(2) Confine the limitation on the use of the rehabilitation tax credit in conjunction with industrial development bond financing to projects to be used by governmental or tax-exempt entities by amending proposed Section 48(c)(vi) as follows:

Substitute for the words "a building" the term " 'tax-exempt use property' within the meaning of Section 168(f)(13)", and in part (I) substitute for the word "building" the word "property".

(3) Provide that H.R. 3110 will not affect economic development projects which are in the planning stage and on which municipalities or other tax-exempt entities have expanded significant effort on the date this bill becomes law.

I urge your attention to these concerns of the City of Boston.

Chamber Of Commerce,
of the United States of America,
Washington, D.C., June 10, 1983.

Hon. Daniel Rostenkowski,
Chairman, Ways and Means Committee,
House of Representatives, Washington, D.C.

Dear Mr. Chairman: On behalf of the U.S. Chamber of Commerce and its 216,000 members, I appreciate this opportunity to express our views on H.R. 3110.

Although we do not fundamentally disagree with the intent of the legislation, H.R. 3110 as introduced is overly broad. If enacted, it would have a major impact on our members who manufacture computers, diagnostic equipment and other similar short-lived assets, as well as the manufacturers of telecommunication and aerospace equipment who must compete internationally. The legislation goes beyond the scope and recommendations of the Oversight Subcommittee's report and should be revised.

CERTAIN SHORT-LIVED ASSETS

In the report, the subcommittee concluded that, under certain tax rules, there is an incentive for a tax-exempt to lease, rather than own, equipment where the lessor of the equipment is eligible for depreciation. It is clear that in some of these cases, recovery deductions can be accelerated to the point where they are received so far in advance of the rental payments used to repay the loan (assuming debt financing) that a substantial deferral of tax to the lessor results.

However, this does not occur in the case of computers and certain diagnostic equipment which have very short economic lives. Technology in these areas changes at a rapid pace. Today's state-of-the-art equipment quickly becomes obsolete. Prior to the Economic Recovery Tax Act of 1981 this type of asset had a useful life under the Asset Depreciation Range (ADR) of 5 years or less in most cases and could be depreciated using the double declining balance method. In adopting the Accelerated Cost Recovery System, (ACRS) Congress did not shorten the lives of these assets, but instead substituted 150 percent declining balance for the double declining balance method. Clearly, short lived equipment under ACRS and ADR does not create an opportunity for unwarranted tax deferral to lessors and should be altered in the pending bill.

Governmental entities and other tax-exempts cannot, in any way, benefit from a law which requires lessors to depreciate short-lived, high technology property over twelve, as opposed to five, years. The total cost of the asset will simply increase, and the result will be a higher cost to the tax-exempt entity with no savings to the Treasury. The only viable choice will be to pay this higher cost for the equipment and take the chance that the equipment will not be obsolete in 24 or 36 months. Many tax-exempts and governmental bodies will have to simply delay and in some cases forego purchase of needed computer or medical or similar diagnostic equipment.

FOREIGN LESSEES

H.R. 3110 eliminates use of the investment tax credit and requires longer class lives with respect to property used by a foreign person where the income from the ultimate use of the property is not subject to United States taxation. There are different economic and trade issues presented by this section of the bill and we agree with Treasury that this section of the bill should be withdrawn for further study. Enactment of this provision will have unintended results, including but not limited to the diminished ability of our domestic manufacturers in the aerospace and telecommunication industries to compete abroad.

I appreciate your consideration of our views and respectfully request that this letter be made a part of the hearings record.

Cordially,

HILTON DAVIS.

CITY OF COLUMBUS, OHIO,
OFFICE OF THE MAYOR,
June 10, 1983.

Hon. J. J. PICKLE, M.C.,
Longworth Office Building,
Washington, D.C.

DEAR REPRESENTATIVE PICKLE: Although I was not able to testify at the hearing on June 8, 1983, I submit this letter and ask that it be incorporated into the official record of the hearing on H.B. 3110.

As you are aware, much of the burden of reduced Federal expenditures has fallen on State and local governments. As a fiscal conservative, I have agreed that we must tighten our belts and absorb our fair share of the cost of financial sanity. However, I was shocked by the attached news report in the Columbus Citizen-Journal of May 27, concerning your proposal to eliminate the sale and lease-back provisions of the Economic Recovery Tax Act. As the article points out, the probable cost—a result of the retroactivity provision of your proposal—will be $85 million from the pockets of Columbus' taxpayers. It is impossible to estimate the longer term impact of eliminating the sale and lease-back option for local governments.

At the time of this writing, it is uncertain whether the City of Columbus, from its own point of view, will proceed to sell the plant. However, I believe that choice should be made in Columbus, and not in Washington. The citizens of Columbus have invested about $170 million of their own money in the plant, and there are no Federal dollars in it. Most cities do not have the opportunity, with their own resources, to deal effectively, and in an environmentally sound way, with the multiple problems of solid waste disposal, resource recovery, and cost containment. Denial of this possibility for financing is counterproductive to both the national and the local purpose.

In fact, the mere announcement that a bill exists, with a retroactivity provision to May 23, has probably destroyed the market potential under the present law, in the absence of prompt and decisive action to remove that cloud.

I believe strongly that the sale and lease-back option and the so-called safe harbor lease retained for municipal use in the Tax Equity and Fiscal Responsibility Act are vital tools for rehabilitation of our deteriorating infrastructure and for necessary municipal improvements. As in the case of our trash-burning power plant, the sheltered income results in great savings to local taxpayers. Moreover, for many cities, these mechanisms are the only alternative because of ceilings applicable to bonded indebtedness. The sale and lease-back has opened new sources of private capital for municipalities and counties, and has allowed local governments to take advantage of private sector efficiency. Most compelling to me is the proposition that the revenue foregone is miniscule compared to the costs of a Federal grant-in-aid program for infrastructure renovation, as proposed by several of your colleagues.

We have studied extensively the use of these tax benefits and find that local governments have used them with prudence and caution to conserve existing facilities and to make necessary expansions to serve increased population. I can tell you that our analysis of using the sale and lease-back of the power plant began in its early construction phase and continues today. However, the apprehension created by the retroactive nature of this proposal creates a level of investor uncertainty that turns the private sector toward other investments outside the public area.

I believe two other important factors should be noted. These tax benefits are not geographically selective, benefiting local governments as diverse as Oakland, Columbus, and counties in New York. Further, the program is equitable to the needs of older cities requiring renovation and conservation as well as newer sites requiring construction for growth. The public interest is well served by these tax concessions to the private sector.

I urge you to consider several modifications of your proposal. Foremost is the elimination of the retroactivity provision, thus allowing the marketplace to operate until this proposal becomes law. Second, I urge you to counsel with other local officials to reach a reasonable compromise that will minimize the impact of this tool upon the tax system; and assure continuation of the orderly conservation and expansion of urban facilities.

Sincerely,

TOM MOODY, *Mayor.*

[From the Columbus Citizen, May 27, 1983]

CHANGE IN LAW MAY BAR SALE OF TRASH PLANT

(By Steve Luttner)

The proposed sale of the city's trash-fired powerplant has been dealt a severe possibly fatal set back.

Strong, bipartisan support has surfaced in both the U.S. Senate and House of Representatives for bills that would prohibit the proposed sale and lease-back arrangement for the plant.

If the bills pass, they would be retroactive to May 23. Columbus officials have not yet decided whether they want to sell the new plant, and they probably are months away from negotiating a sale if City Council approves such a proposal.

City Auditor Hugh Dorrian, a strong proponent of the sale of the trash plant, said yesterday he believes the proposal now is doomed, even if the House and Senate bills aren't passed.

"I'm terribly pessimistic about it right now," Dorrian said in an interview. "The bill will essentially prohibit the sale and lease-back by municipal governments of capital assets. Unfortunately, I don't think the issue is whether the bill passes or not, insomuch as it means the market (for the sale of the plant) will be destroyed."

Dorrian said private investors who may have considered buying the plant to realize significant tax advantages will become "much more wary" because of the proposed legislation in Washington.

He said he was informed of the House bill yesterday morning by the First Boston Corp., a New York City investment banking firm that would serve as the broker for the city if the plant were sold.

U.S. Rep. J.J. Pickle, D-Texas, is co-sponsor of a bill introduced last week that would halt sale and lease-back arrangements now being proposed by dozens of city governments across the country, including Columbus.

The sale and lease-back arrangements, a by-product of the Economic Recovery Tax Act of 1981, permits corporations and other private investors to realize substantial federal tax savings by buying property from cities and other tax-exempt institutions.

For example, investors buying the Columbus plant would have paid about $170 million for the facility and would have been allowed to write off 100 percent of that investment in the first five years of their ownership.

The city would have leased the plant back from its new owners. Dorrian estimated that Columbus would have saved $85 million during the — year life of the lease because it would cost the city less to lease the plant than to retire the $162 million in debt it has incurred to build the facility.

"I'm disappointed in the conclusion of this," Dorrian said. "We had an enormous benefit waiting to be grasped."

An aide to Pickle said Pickle's bill is cosponsored by five Republicans and five Democrats, all members of the House Ways and Means Committee.

Sen. Howard Metzenbaum, D-Okla, said in a press release Tuesday that he and Sen. Robert Dole, R-Kansas, "are planning to introduce legislation to halt the practice of 'sale and lease-backs' now being extensively used by local governments and tax-exempt institutions."

CRANSTON DEVELOPMENT CORP.,
Columbus, Ohio, June 9, 1983.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. SALMON: I am writing this letter on behalf of Cranston Development Company as a developer and as an historical rehabilitator. Our company's focus and sole area of development is historical rehabilitation, so with considerable experience behind us and with approximately $100 million of historical projects hanging in the balance, we respectfully submit the following comments on H.R. 3110.

Successful rehabilitation is contingent upon a myriad of factors, most of which are economic. Regardless of the historical significance of a structure, the fact is, with the possible exception of residential properties, the economic substance of rehabilitation dictate whether or not a project is undertaken. As with any commercial venture, the economic realities and consequences control.

It is in consideration of these economic factors that an historical development is structured. Because historical preservation is so costly (we currently average $61–62 a square foot), acquisition costs are not eligible for ITC consideration and developers need to enter the marketplace with a commercial building that is competitive, competitive financing is required. Thus, the use of IDBs is desirable. Because the projects suit the intended purposes of IDBs, their use is common and appropriate.

Historical preservation is a costly and time consuming process. It necessitates a happy marriage between the development, state and federal participants and incentives are necessary. It was in consideration of this situation that Congress enacted the legislation that facilitated historical preservation and development.

Congress realized that private funds had to be enlisted to save historical structures. The growth in historical preservation is proof of their foresight and the correctness of the need for incentives.

In reliance on Congress' encouragement and representations, developers, communities and investors have committed themselves to projects involving historical preservation. We have all done what you encouraged us to do. Now, with the introduction of H.R. 3110, you propose to shut the door on projects where considerable sums of time and money have been expended. The proposed legislation has no provision to grandfather projects that were undertaken in consideration of the law and thus, has a penalizing effect. This reliance was justifiable and economically based. The fact is, our commercial developments would not be economically sound without IDBs and would not have otherwise been undertaken.

We, of course, stand to lose a great deal. The legislation will destroy projects that we have underway and have been working on for years. The economic consequences are severe as well. The cities and private investors that are involved will be severely economically penalized for their involvement. We will face unavoidable and certain economic hardship.

Our company and project paticipants are not alone in this posture. We ask you to consider the consequences that H.R. 3110 has upon existing projects and suggest that its terms be modified to allow projects which are substantially underway to be completed under the terms of the law on which they were lawfully begun.

Obviously our first choice would be to drop the proposed legislation. Our firm second choice is to implore that fair consideration be given to those who relied on the word of Congress and the law.

Respectfully submitted.

Robert C. Kanuth, Jr.,
Chairman.

Federal National Mortgage Association,
Washington, D.C., June 14, 1983.

Re H.R. 3110.

John Salmon, Esq.,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Mr. Salmon: Representative J. J. Pickle (D-Tex.) has introduced legislation intended to establish a new set of income tax rules for certain types of financing arrangements between taxable and tax-exempt entities. Mr. Pickle's proposal, H.R. 3110 (the "Bill"), was the subject of hearings in the Committee on Ways and Means on June 8th.

I have examined the Bill on behalf of the Federal National Mortgage Association ("FNMA") and am concerned that, contrary to the apparent intent of its sponsors, the Bill may affect certain taxable enterprises, such as FNMA. This letter is the result of a brief discussion of this matter you have had with Lawrence F. O'Brien, Esq., of Dewey, Ballantine.

The Bill deals with certain transactions of "tax-exempt entities," which are defined to include, inter alia, "any agency or instrumentality of the United States." However, FNMA and some other institutions that are not exempt from federal taxation are, at least for certain purposes unrelated to the Internal Revenue Code, considered to be agencies or instrumentalities of the federal government.

For example, FNMA, a fully taxable, shareholder-owned corporation, whose stock is traded on the New York Stock Exchange, is required by statute to insert language in its obligations "clearly indicating that such obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any *agency or instrumentality thereof other than the corporation.*" 12 U.S.C.A. §1719(b) and (e) (emphasis added).

Thus, it is possible that the Bill's definition of a "tax-exempt entity" could be construed to include certain tax-paying organizations, such as FNMA. Any such construction would, of course, be ironic in light of FNMA's status as a taxypayer at the full corporate level. We do not believe it to be the result intended by the Bill's proponents. Therefore, we respectfully request that the Committee consider drafting its legislative history so as to make clear that taxable entities, such as FNMA, are not "tax-exempt entities" under the Bill.

We very much appreciate your attention to this matter. If you have any question, we would be pleased to respond.

Sincerely,

CARYL S. BERNSTEIN,
Executive Vice President,
General Counsel, and Secretary.

STATEMENT OF J. WILLIAM FREDERICKSON, PROFESSOR OF ECONOMICS, NORTH PARK COLLEGE, CHICAGO, ILL.

Inclusion of private non-profit organizations and agencies with governmental agencies as subject to the provisons of H.R. 3110, is neither logical as a concept nor sound as policy. Most of the examples cited in background materials refer to governmental agencies, and it is understandable that the proliferation of sale/leaseback projects by government should arouse Congressional concern and lead to corrective legislation. The application of H.R. 3110, to PRIVATE non-profit organizations, impacts an entirely different group of entities, that are in a different situation, and deserve separate consideration.

Private non-profit organizations, particularly private colleges and universities, are already struggling with the consequences of reductions in Federal and state funding. My own college has had to divert privately raised fund to scholarships to continue to meet student need in the face of government cutbacks in this area. This means less money for other purposes, including building maintenance and rehabilitation. The sale/lease back arrangement has appeared as a most helpful way of securing financing for badly needed and long deferred rehabilitation. In most cases it would have a limited application to one or two buidings. For this group of institutions to use the sale/leaseback possibility, could never create a "staggering revenue loss," nor add significantly to the Federal deficit.

North Park College has been working on the possibility of a sale/leaseback arrangement to complete the financing of the rehabilitation of its Old Main building, recently declared a national historic landmark. About half of the funds needed have already been raised through private contributions; and the sale-leaseback would enable the institution to complete the project.

I suggest to the committee that it consider the following:

(1) The H.R. 3110, or any legislation with the same intent, should NOT apply to private colleges and universities, or other private non-profit institutions and agencies.

(2) That buildings designated as Landmarks, be exempted completely for all tax-exempt entities including local government.

(3) That the effective date of application of any changes in the laws regarding this matter be the date of passage of the bill, not its introduction.

STATEMENT OF DANA G. RINEHART, TREASURER, FRANKLIN COUNTY, OHIO

I recently became aware of proposed legislation now pending before Congress that would eliminate the sale-leaseback financing concept. While I am not opposed to the general thrust of this bill, I am quite concerned by its inclusion of local governments among the organizations that would lose the use of this valuable fiscal management tool.

Municipalities across America have used sale-leaseback to their great advantage as a means for cutting costs or raising badly needed short-term revenue through the sale of tax benefits inherent in capital assets. Loss of sale-leaseback now would work a particular hardship on local governments throughout Ohio, which are already hard-pressed for new revenue sources in the wake of federal funding cuts and the recent 90 percent increase in the state income tax.

In Columbus, the Central Ohio Transit Authority hopes to save $500-$750 thousand through a sale-leaseback arrangement on over 150 buses. Additionally, the City of Columbus is now considering the use of this financing tool in the acquisition of new garbage trucks, and for several other projects. And, as a candidate for Mayor of Columbus, I have already proposed using sale-leaseback in the rehabilitation of several old City buildings.

Thus, I am very much opposed to this bill in its current form, and urge that it be amended to exclude municipalities. I would be delighted to meet with members of the House Ways and Means Committee to discuss this matter futher.

STATEMENT OF THE HEALTHCARE FINANCIAL MANAGEMENT ASSOCIATION

The Healthcare Financial Management Association (HFMA) is pleased to submit the following views concerning H.R. 3110, "The Governmental Leasing Tax Act of 1983." HFMA is a professional society of more than 22,000 members who are directly or indirectly associated with financial management in hospitals and other healthcare organizations. These individuals are involved in arranging for the financing of healthcare facilities and recognize the essential role of leasing in meeting community healthcare objectives.

The Committee on Ways and Means Subcommittee on Oversight has observed some instances of use of leasing arrangements not anticipated by Congress and possibly not in the public interest. We are pleased to note that none of the circumstances cited by the subcommittee involved hospitals or other types of healthcare institutions. We believe that in the case of healthcare facilities, the accelerated cost recovery system (ACRS) and the investment tax credit (ITC) serve valid public purpose objectives and therefore we do not support H.R. 3110, "The Governmental Leasing Tax Act of 1983" as it relates to healthcare facilities. We believe that H.R. 3110 would have a number of unintended consequences that would be adverse to hospitals and other healthcare organizations, to the government and to the public. The proposal would:

(1) Eliminate the transfer of obsolesence risk on high technology equipment from healthcare facilities to lessors.

(2) Impose a useful life schedule that is out of step with economic reality.

(3) Introduce an undesirably artificial difference in access to capital between tax-exempt and investor-owned healthcare facilities.

(4) Reduce the availability of essential capital obtained through leasing to many healthcare facilities which are most in need.

Recent advances in equipment-embodied medical technologies have resulted in rapid technological obsolescence. For example, certain types of diagnostic equipment can become outdated to the needs of a specific organization in as little as three years. Because of obsolescence and rapidly increasing maintenance costs, the actual economic decline in value is more accelerated than straight-line depreciation. Because of this, prudent healthcare financial managers often shift this risk of technological obsolescence to a lessor. In some instances lessors remarket the equipment to other organizations. To a certain extent, the risk that the lessor accepts is partially offset by the tax advantages available to the lessor through the existing accelerated cost recovery system. If the ACRS were not available to the lessor (as would appear to be the case if H.R. 3110 were enacted), lessor organizations have told HFMA that it would no longer be economically feasible to enter into lease arrangements with tax-exempt hospitals.

The depreciation rate allowed by ACRS is, in many cases not significantly dissimilar from the loss in economic value of the leased equipment. The requirements of H.R. 3110 to use extended lives and straight-line depreciation are out of step with economic reality. These rules would require that hospital equipment be depreciated far more slowly than its economic decline in value. It is essential that the law use useful lives and depreciation methods that are economically realistic.

Hospitals and other healthcare organizations are unique in the ownership may be tax-exempt, governmental or investor-owned. Facilities of different ownership types may be very similar in all other respects, such as size and services provided. These facilities may be located in close proximity and compete for the same patients and medical staff. If H.R. 3110 were passed, investor-owned facilities would still be able to use ACRS and ITC but tax-exempt and governmental-owned facilities could not benefit from these provisions, even indirectly as is now possible. This differentiation in access to capital on the basis of ownership-type seems unnecessary and undesirable.

Many hospitals and other healthcare facilities suffer from severe cash flow and credit problems that restrict their ability to purchase assests needed for patient care. Consequently, these organizations often utilize lease transactions as a means of obtaining the use of property that would otherwise not be possible. Hospitals serving the highest proportion of charity services tend to be those with the weakest financial position. Cash flow and credit problems effect the cost and availability of capital forcing these organizations to rely on lease transactions. If H.R. 3110 resulted in government-owned and tax-exempt hospitals being closed out of leasing transactions (as we believe would be the case), then this important form of financing would be lost by these institutions. A subsequent result would be a gradual diminuation in the qualilty of services rendered by these institutions due to their inablility to acquire the most appropriate and cost-effective equipment.

The hearing record of the Oversight Committee implies that action is needed because federal government entitles and tax-exempt organizations have no liability to pay federal income tax therefore should be denied the benefit of ACRS and ITC. We believe this is incorrect for hospitals and other healthcare organizations. Tax-exempt healthcare organizations pay taxes on unrelated business income, as well as payroll and excise taxes. In addition, healthcare providers—and hospitals in particular—are subject to a "hidden tax" due to their participation in the Medicare and Medicaid programs. As this committee has heard in prior testimony, the federal government does not pay the full economic costs incurred by institutions providing services to Medicare and Medicaid beneficiaries. Recently, the term "cost shifting" has been used to describe the necessity that hospitals set charges for their private-pay and commercially-insured patients at a higher rate than would otherwise be necessary in order to compensate for inadequate payment by Medicare and Medicaid known as "shortfalls." Professor Hugh Long of Tulane University has observed, "The reality is that government, by taxing the provider heavily via cost-based reimbursement, is relying on the provider to pass that tax through to other patients. Thus the provider has been forced into a quasi-governmental role in which one segment of patients (charge-payors) is taxed to subsidize other segments (cost-payors and nonpayors)."[1] Consequently, it would be rare to find a tax-exempt healthcare organization that would experience a "negative effective tax rate" due to its participation in leasing transactions in which a portion of the tax benefits available to the lessor may be passed through to the tax-exempt lessee in the form of lower rent.

In conclusion, HFMA urges the committee to tailor the provisions of the bill more specifically to the abuses observed and give consideration to the special circumstances of hospitals and other healthcare organizations by exempting these institutions from the provisions contained in H.R. 3110. The time available for preparing these views has only permitted limited discussion with members. If relevant case examples or other information is obtained that will be useful to the committee, we will provide this information. We appreciate this opportunity to present these views. We would be pleased to answer any questions which may be directed to Ronald Kovener, Vice President or Walter Unger, Associate Directors, Professional Affairs, in HFMA's Washington office.

HERRICK HOSPITAL AND HEALTH CENTER,
Berkeley, Calif., June 8, 1983.

JOHN SALMON, Esq.,
Chief Counsel, House Ways and Means Committee,
Longworth Building, Washington, D.C.

DEAR MR. SALMON: Herrick Hospital and Health Center, in Berkeley, California is opposed to H.R. 3110 because it will further restrict certain tax advantages available to non-profit community hospitals. Such advantages are necessary if non-profit hospitals are to remain viable and to continue serving all citizens of the community. Both proprietary and non-profit hospitals are faced with the dilemma of having more intensive capital needs (i.e., acquisition of modern equipment and development of responsive patient care programs) in a climate of declining third-party reimbursements and increasing costs of financing. Non-profit community hospitals must meet their obligation to save lives through the use of the best equipment and highly trained personnel, but will be greatly hindered by this and other legislation which proposes to take away revenue sources. This legislation will particularly impact community hospitals dedicated to the care of the indigent.

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[1] "Preserving Capital," August 1982, Healthcare Financial Management Journal, p. 46.

We strongly discourage the passage of H.R. 3110 and thank you for considering these comments in the Committee's hearings.

Sincerely,

HERSHEL W. SHELTON,
Executive Vice President.

STATEMENT OF ROBERT HOGUET, VICE PRESIDENT, KIDDER, PEABODY & CO., INC.

INTRODUCTION

I am Robert Hoguet, a Vice President of the investment banking firm of Kidder, Peabody & Co. Incorporated. My main area of professional involvement is public finance. I am the Managing Officer of the Solid Waste Group within Kidder, Peabody's Public Finance Department. In that capacity, I am responsible for all tax exempt financings on behalf of Kidder, Peabody's municipal and corporate clients.

I am pleased to state that Kidder, Peabody & Co. Incorporated is the leader in the financing of waste to energy facilities.

TESTIMONY

The restriction of tax benefits as set forth in H.R. 3110 should not apply to transactions such as solid waste disposal where the community is receiving an essential public service from a taxparyer. Our concern arises from the bill's ambiguous phraseology relating to long term contracts between government units and taxpayers providing a service.

Neither governmental units or owner/operators are trading on a state or local government income tax exemption. If a governmental unit chooses to own a solid waste facility, no tax incentives are available. If, instead, a taxpayer owns and operates such a device, it is subject to Federal income tax laws, i.e., its income is not sheltered because it has a contract with a tax-exempt entity. From the owner/operator's standpoint, the only reason for entering into the transaction is profit. Such a taxpayer's risk is major, i.e., the owner's damages for failure to perform are severe, and he is subject to changing energy prices. Finally the facility and personnel are subject to his control.

The principal problem of solid waste disposal refuse to energy facilities in lieu of landfill is the immediate high capital cost for a plant. The combination of ACRS, ITC and tax-exempt financing available where a facility is owned and operated by a private entity which provides solid waste disposal services to a community is helping to overcome this problem. As a general rule, raw landfill is cheaper to a community for about as much as a decade but certainly wasteful in terms of land use and energy policy; moreover, unsound environmentally. Unfortunately, these initially higher costs are deterring many communities from pursuing waste to energy plants as a long term solution to their garbage disposal problems. Accordingly, a shrinkage of tax incentives would be counterproductive to the nation's environmental policy (increasing the cost of service will delay switching from raw landfill) and energy policy (raw landfill foregoes the potential heat value obtained from incinerated trash).

The development of waste to energy plants is an extremely long and costly process. It is not unheard of for a faciltiy to take up to ten years from initial conception to implementation. Private and public sector participants together spend millions of dollars during that time. Given these circumstances, it is important from a national policy standpoint that as stable an atmosphere as possible prevail, so that planning may proceed in an orderly progression. Only last year, the 96th Congress considered the same issues which are addressed by H.R. 3110, and determined that the tax benefits available under current law should prevail. We see nothing which has occurred in the last twelve months which should cause a reversal of the policy decisions in this regard which were reached in 1982.

Additional reasons for not restricting current tax incentives for public use facilities, such as solid waste are:

(1) A governmental unit's purchase of service such as garbage treatment from a taxpayer is neither a nefarious nor sham transaction; and accordingly, tax laws should not discriminate against either the community purchasing the service or the owner/operator which provides it. The committee should except from its contract rule transactions involving necessary community services such as solid waste projects, water transmission facilities and sewer plants.

(2) Where a service agreement does not shift the real benefits and burdens of ownership to the community, neither the community nor the operator should lose tax benefits which are available under current law. Nor should the Committee be concerned about a so-called "double-dip." The only unique tax incentive for these types of facilities is the availability of tax-exempt financing. ITC and ACRS operate as a capital formation tool as they do for any other taxpayer making a capital expenditure.

(3) The services are not related to a select group such as municipal employees in an office building or sports fans at a stadium but rather apply to *all* of the citizenry within the facility service area. In fact, solid waste disposal services from refuse to energy facilities are generally available to customers other than a prime community, i.e. private haulers, commercial trash and neighboring jurisdictions.

(4) It would be ironic for the Federal government, first, to eliminate its grant programs dealing with the elimination of garbage on the premise that private industry should handle the issue and subsequently penalize the solid waste industry for filling the void.

Current law, in addition to supplementing sound environmental and energy policy, aides this industry in obtaining capital. Regression of existing law could well delay projects with the consequent death knell of the industry.

LAVENTHOL & HORWATH,
Washington, D.C., June 7, 1983,

Re H.R. 3110.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE: We appreciate this opportunity to comment on the proposed Governmental Leasing Act of 1983 (H.R. 3110) and I am submitting these comments on behalf of all taxpayers and residents of municipalities who may be adversely affected by the provision of H.R. 3110 relating to proposed changes in the credit for rehabilitation of qualified buildings.

Laventhol & Horwath is a national firm of certified public accountants with 41 offices in major cities throughout the United States. We are a member of Horwath & Horwath International, whose affiliated firms encompass more than 150 offices in over 70 countries around the world. We serve many clients in the real estate industry.

H.R. 3110 proposes to eliminate "indirect subsidies" by the Treasury Department to tax exempt organizations, which result from the sale by them of tax benefits to taxable entities through sale and leaseback transactions. I will not comment on the substance of the proposed legislation. Rather, I will confine the scope of my remarks to what I see as technical incongruities in the bill as it is proposed. The recommendations of the House Oversight Subcommittee and the examples of problem areas address the use of tax benefits by tax exempt entities though sale and leaseback transactions. There was at no point any distinction drawn between the "sale" by tax exempt entities of ACRS depreciation and the "sale" of rehabilitation credit. However, in the drafting of H.R. 3110 the treatment of these two tax benefits is dramatically different. The proposed legislation as it concerns ACRS would discourage tax exempt sale leasebacks as follows: first, it focuses on the situations that brought this issue to light, i.e., those situations where tax exempt entities are lessees. Second, the bill reduces the tax benefits to discourage these tax motivated transactions. Finally, it has an effective date which recognizes the cost to parties of negotiating financial arrangements and it "grandfathers" property placed in service pursuant to a binding contract finalized as of May 23, 1983.

The provision dealing with the rehabilitation credit addresses the problem as follows: first, it focuses on the industrial development bond financing arrangements, disregarding the issue of whether a tax exempt entity or a leasing transaction is involved. Second, when industrial development bonds are used in connection with any portion of a building either directly or indirectly, the entire property is disqualified for the credit. Finally, the effective date is for property placed in service after May 23, 1983.

As you can see, the treatment of the two tax attributes, although not distinguished in the hearings, recommendations of the chairman, or in any other public forum, are most clearly differentiated in H.R. 3110.

I would suggest that the difference between the treatment by H.R. 3110 of ACRS depreciation and the rehabilitation credit reflects significantly different policy issues. I would also suggest that if the credit is to be treated as an industrial bond financing issue, it would be more appropriate to address this in separate hearings.

I would like to devote the remainder of my comments to examining the differences in the treatment of ACRS and the rehabilitation credit by H.R. 3110.

As I indicated, the focus of the ACRS provisions of H.R. 3110 is on tax exempt lessees, whereas the focus of the credit provisions is on industrial development bond financing. The result of the change in focus is that instead of tax exempt lease arrangements being penalized, all forms of industrial development bond financing are penalized. The hearings found what they considered a problem and recommend a solution. The solution does not fit the policy recommendation. The legislation should be narrowly focused to address the policy issue at hand i.e. tax exempt user property. Although in some of the examples sale and leaseback transactions, which the Oversight Committee considered, industrial development bond financing was used, it was not the industrial bond financing that motivated the project. In fact, special tax status has been specifically granted to industrial development bonds to encourage urban development. By penalizing IDB financing H.R. 3110 is addressing a completely different policy issue, which may have a substantial impact on urban development and the real estate industry which has only recently shown signs of recovering from one of the most severe slumps in history.

In addition, the elimination of the credit for direct or indirect connection with industrial development bonds is very harsh. The net effect of the tax exempt nature of the bonds is a savings of approximately two or three percent over commercial financing. As the law stands currently, IDB financed projects must already give up accelerated depreciation, and adopt straight line depreciation. By tainting all IDB financed projects with the additional loss of the rehabilitation credit (which can be as high as twenty-five percent of the cost of a development), H.R. 3110, as indicated before severely undermines the effectiveness of the industrial development bonds.

Another difference between the ACRS and credit provisions of H.R. 3110 is in the effective dates. Both should recognize projects pursuant to binding contracts. It does not make sense to exclude tax exempt organizations with binding contracts from the provisions of H.R. 3110 but penalize taxable entities with binding contracts and yet the two different effective dates do just that.

In conclusion, technically the credit restrictions of H.R. 3110 as currently drafted, exceed the scope of the hearings and address different policy considerations which should rightly be separately addressed. The elimination of the rehabilitation credit for direct or indirect use of industrial development bond financing appears to be an extremely harsh penalty which may adversely affect urban development, and the effective date differences unfairly penalize taxable entities with binding contracts. In the event industrial development bonds are perceived as a problem, restrictions on tax benefits related to those projects should be addressed in separate hearings. Finally, the effective date of the two provisions should recognize binding, negotiated contracts for both taxable and tax exempt organizations.

Sincerely,

Albert B. Ellentuck,
National Tax Partner.

City of Los Angeles,
Office of the Mayor,
Los Angeles, Calif., June 9, 1983.

Subject: H.R. 3110, The Governmental Leasing Act of 1983.

Hon. Dan Rostenkowski,
Chairman, House Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Mr. Chairman: The City of Los Angeles, California, through its Community Redevelopment Agency, requests the opportunity to submit this statement as part of the written record of the hearing held on June 8, 1983 by the House Committee on Ways and Means on H.R. 3110, the proposed Governmental Leasing Act of 1983 introduced by the Honorable J. J. Pickle of Texas.

We believe that your committee will want to know that H.R. 3110, in the form in which it was introduced on May 24, 1983, would abort the private investment of hundreds of millions of dollars in specific developments which are in advanced stages of planning for construction as part of the 35-year-old redevelopment program in downtown Los Angeles.

Already hundreds of thousands of dollars of public and private planning funds have been invested in these prospective developments on the assumption that the current Internal Revenue Code regulations would continue to afford tax incentives to private investors who are cooperating with the City of Los Angeles in our joint efforts to rebuild or rehabilitate older and deteriorating sections of the downtown district.

Suddenly, with the unexpected introduction of H.R. 3110 followed by your committee's hearing on the bill only fifteen days later, we are confronted with the possibly abrupt loss of these tax incentives and, as a consequence, the loss of commitments by private investors who have been acting in good faith.

Perhaps, as Congressman Pickle has stated in the Congressional Record of May 24, 1983, the tax incentives dealth with in H.R. 3110 have led to "abuses," but we are confident that the proposed developments in downtown Los Angeles that would be affected by this bill are firmly grounded in public and private purposes which cannot in any sense be considered "abuses" of public policy.

In the belief that adverse consequences of the kind that would occur in the City of Los Angeles were not envisioned by the sponsors of H.R. 3110, we wish to identify the developments to which we refer, to explain their public and private purposes and to appeal for your consideration of amendments to H.R. 3110 that would accommodate our long-term objectives of improving economic and social conditions in downtown Los Angeles.

You will note, in examining the attached list of prospective developments, that each of them is in a redevelopment project area formally designated by the Los Angeles City Council in accordance with the Community Redevelopment Law of the State of California, and many of the proposed developments are to take place in buildings listed on or eligible for listing on the National Register of Historic Structures and/or are in the Spring Street National Register Historic District or in the Broadway National Register Historic District, all in downtown Los Angeles.

All of these planned developments, long sought by the City of Los Angeles as part of its publicly supported downtown revitalization program, would be rendered financially infeasible through the loss of rehabilitation tax credits for tax-exempt-financed developments, or the loss of leaseback credits or the elimination of other tax incentives as proposed in H.R. 3110.

We wish to suggest that your committee and the sponsors of H.R. 3110 might explore ways of achieving the elimination of the abuses to which Congressman Pickle refers without, at the same time, depriving cities of these tax incentives as means of enlisting private capital in the revitalization of the wealth-producing bases of core areas.

We suggest that this might be accomplished by excluding structures in publicly assisted redevelopment projects and in nationally designated historic sites from the proposed restrictions of H.R. 3110.

We also wish to suggest a modification of the requirement in H.R. 3110 that a "written binding contract" for a proposed development must have been in effect on May 23, 1983 as a qualification for exemption from the provisions of H.R. 3110. We believe that cities should be allowed to present other evidence that substantive steps had been taken before May 23, 1983 toward the achievement of the proposed developments and that these pre-contract measures may be considered as qualifications for exemption from H.R. 3110.

The City of Los Angeles appreciates the opportunity to submit this statement on H.R. 3110 to your committee. We will be grateful for the committee's consideration of our recommendations.

Sincerely,

JOHN FERRARO,
Chairman, Intergovernmental Relations Committee, Los Angeles City Council.
TOM BRADLEY,
Mayor.

[Attachment]

[Dollars in millions]

Proposed development	Location/designation	Purpose	Estimated private investment
1. Central Library	Central business district (CBD) redevelopment project. Los Angeles Historic-Cultural (L.A.H.C.) Monument. National Register of Historic Places	Rehabilitation and expansion of the seriously overcrowded and unsafe Central Library building, one of the City's most significant historic structures. (A proposed $200 million office building, entirely financed with private capital without any tax incentives, is contingent on the Central Library project across the street).	$60 to $70.
2. Garfield Building	CBD redevelopment project L.A.H.C. Monument National Register of Historic Places	Rehabilitation/restoration of 92,000 s.f. office building. Rehabilitation will result in revitalization of an area with high amount of vacancy.	$9.3.
3. Embassy Hotel	CBD redevelopment project Eligible for National Register of Historic Places.	Develop 250 hotel rooms, performing arts center and commercial space as stimulus to a residential community in downtown.	$5 to $7.
4. Center for the Preservation of the Variety Arts.	CBD redevelopment project L.A.H.C. Monument eligible for National Register of Historic Places.	Rehabilitate and modernize the Historic Friday Morning Club building supporting commercial space.	$3 to $5.
5. Former Standard Oil Building.	CBD Redevelopment project Eligible for National Register of Historic Places.	Conversion of a 10-story office building to residential apartments.	$7 to $10.
6. Loft Building at 11th & Hope.	CBD Redevelopment project	Conversion of 70,000 s.f. loft to mix of apartments and commercial space. Structure is over 40 years old.	$5 to $7.
7. California Hospital 1926 wing.	CBD Redevelopment project	Conversion of abandoned hospital to a medical office building of apartments. Structure is over 40 years old.	$10.
8. Commercial Exchange Building.	CBD Redevelopment project	Rehabilitation of 100,000 s.f. office building to apartments, office, and retail space. Structure is over 40 years old.	$7.
9. Insurance Exchange Building.	CBD Redevelopment project	Rehabilitation of 120,000 s.f. building for mixed residential and commercial use.	$7.
10. Bullocks	CBD Redevelopment project Broadway National Register Historic District.	Conversion of abandoned department store to mixed commercial and retail uses to result in revitalized Broadway and Seventh Street Retail District.	$10.
11. Pacific Coast Stock Exchange Building.	CBD Redevelopment project Spring Street National Register Historic District.	Adaptive Re-Use of former stock exchange.	$3.
12. Metropolitan Water District Building.	CBD Redevelopment project Broadway National Register Historic District.	Mixed-Use adaptive reuse of office space above commercial uses.	$3 to $5.
13. Arcade Building	CBD Redevelopment project, Broadway and Spring Street. National Register Historic District	Mixed-Use rehabilitation for professional offices, retail, galleries, and apartments.	$7.
14. May Co.	CBD Redevelopment project National Register of Historic Places	Adaptive Re-Use of upper floors of former department store building.	$9.
15. Eastern Columbia Building.	CBD Redevelopment project National Register of Historic Places	Office rehabilitation	$5.
16. Robinsons Department Store.	CBD Redevelopment project	Re-Use of upper floors	$2 to $5.
17. Barker Brothers Building	CBD Redevelopment project	Rehabilitation	$2 to $3.

Proposed development	Location/designation	Purpose	Estimated private investment
18. Equitable Building	CBD Redevelopment project	Rehabilitation	$2 to $3.
19. Earthquake Resistance Rehabilitation Program.	CBD and other redevelopment project areas and historic areas.	Rehabilitation of major older office buildings, hotels and other residential buildings, many of them occupied by lower income residents, to bring the building up to seismic standards for earthquake resistance.	$200.

City of Louisville Office of Economic Development,
Louisville, Ky., June 7, 1983.

Ways and Means Committee,
House of Representatives,
Washington, D.C.

Dear Members of the Ways and Means Committee: As President of the Louisville Industrial Development Authority, I am writing to express our opposition to H.R. 3110. The LIDA Board of Directors met today and approved a resolution opposing Representative Pickle's bill.

Passage of this legislation would jeopardize approximately $65 million in rehab projects. These include Heyburn Building, Republic Building, Starks Building, Paradis Parish School, Sixth Avenue Associates, Levy Brothers, Phoenix Hill Redevelopment, and approximately Seven West Main Street projects.

The availability of IRB's combined with tax credits have had a very positive effect on the amount and quality of rehabilitation that has taken place in central Louisville. These financing mechanisms have made revitalization of older buildings a viable alternative to demolition and new construction. The projects already accomplished, and those planned, add importantly to our tax base and provide for creation of new jobs.

H.R. 3110 also curbs the sale-leaseback of public buildings through which cities and other tax exempt entities pass the value of tax breaks on to private investors. It is imperative that our nation's cities retain every possible financing mechanism and oppose additional restrictive covenants.

The use of Industrial Revenue Bonds has not only added to vast improvements in Downtown Louisville but has been an incentive to the private investor in financing approximately $100 million worth of rehabilitation projects within our City. H.R. 3110 is in effect destroying the incentives to participate in a sound recovery program. We strongly urge you to exert your best efforts in the defeat of this legislation.

Sincerely,

James F. Tate,
President, Louisville Industrial Development Authority.

Congress of the United States,
House of Representatives,
Washington, D.C., June 3, 1983.

Rep. Dan Rostenkowski,
Rayburn HOB,
Washington, D.C.

Hon. Mr. Rostenkowski: This letter is in reference to your proposed legislation, H.R. 3110. One of my constituents recently informed me concerning the expected impact H.R. 3110 will have on a rehabiilitation project in Racine, Wisconsin.

Enclosed is a self-explanatory letter from my constituent, concerning the problems he expects to encounter if this legislation should pass in its present form. I am requesting that at the public hearings for H.R. 3110 my constituent's concerns be given consideration.

Please keep me advised concerning future action taken on H.R. 3110.

Sincerely,

Les Aspin,
Member of Congress.

THE MILWAUKEE COMPANY PROPERTIES, INC.,
Milwaukee, Wis., June 1, 1983.

Mr. LARRY NEBLOCK,
c/o Congressman Aspin,
Janesville, Wis.

DEAR MR. NEBLOCK, I am writing to you concerning HR #3110 and the impact that this will have on a rehabilitation project that my company is undertaking in downtown Racine, Wisconsin.

On March 22, 1983 the Milwaukee Company Properties, Inc., a taxable entity, purchased the Elks Building from the Racine Elks for $250,000. The building is located adjacent to a blighted district in the downtown area and we applied for and received Industrial Revenue Bonds in the amount of $2,000,000. The building was declared eligible for Historic Designation in 1978 and we have been pursuing this designation concurrently with obtaining the IRB'S.

Our plan is to renovate the building into first class office space for use by commercial tenants. We had entered into a preliminary contract with a contractor and architect, prior to purchasing the building, hired a leasing agent, and had 40 percent of the building preleased.

We were scheduled to begin construction next week when I heard about the impact this bill would have by disallowing Investment Tax Credit if IRB financing were used.

This is the first renovation project of this size in downtown Racine and is possible only because of the favorable financing provided through IRB'S in conjunction with the Investment Tax Credit allowed for rehabilitation costs. If we are precluded from using the IRB'S or receiving the Investment Tax Credit, this project will not be feasible.

To date we have spend approximately $300,000 and many man hours developing what we hoped would be not only an attractive investment but a pioneering effort in a blighted downtown area. The project is on hold until we find out if we will be able to proceed according to our original assumptions.

Sincerely,

DAVID K. WESTBY,
Vice President.

MINNEAPOLIS, CITY OF LAKES,
June 9, 1983.

Representative DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: The City of Minneapolis appreciates this opportunity to provide written testimony in opposition to H.R. 3110, which was before the Ways and Means Committee on June 8, 1982. In addition, we have enclosed a brief description of projects that are affected by the provisions of the bill.

While there are a number of provisions in the bill that could have a potentially destructive impact on the City's development efforts our testimony focuses on the provisions that prevent the use of both tax/exempt industrial development bond financing and any rehabilitation or historical tax credits on a single project. These provisions not only restrict the structuring of future projects, but could be devastating to projects that have not only received the proceeds of IRB issues, but are currently under construction. The May 23rd 1983 "in service" date required by H.R. 3110 appears to prohibit these projects from using both the tax credits and IRB financing. To imperil the financing of projects during the construction phase, because of a retroactive effective date, goes too far. At the least, more reasonable transition provisions are needed to protect cities and investors who have relied on the combination of credits and IRB financing to make a project financially feasible. Transition provisions, however, are a weak response to the larger issue. What tools are cities to be allowed to deal with urban decay?

With each passing year, older, mature cities have had to work with fewer tools and less funding to redevelop decaying and blighted areas and buildings. Cities have turned to packaging various financing tools to leverage scarce federal and local redevelopment dollars. More recently, cities have rediscovered the usefulness, beauty, and historic significance of older districts and buildings. Preservation has become a goal of elected leaders, and whole communities. Often the rehabilitiation of a decaying structure can be the turning point for a neighborhood, and provide a focus for civic pride. Without creative and innovative financing efforts, the dollars and cents choice for a developer would be to tear down the buildings because rehabilitation of an older structure can be prohibitively expensive. As a practical matter, with reduced federal involvement in urban development, we look to the tax code for assistance in doing the right thing. Without credits and tax-exempt financing and without any other financial assistance we are dooming local efforts at rehabilitation and giving up the dream of strong, vital central cities, providing jobs and a future to all their inhabitants.

Sincerely,

Mayor DONALD FRASER.
Alderman ALICE RAINVILLE,
President, City Council.

CITY OF MINNEAPOLIS IRB/REHABILITATION PROJECTS AFFECTED BY H.R. 3110

	IRB bond	Date of prel.	Date of final	Issuance date	Proposed reuse	No. of new jobs
Crown Mill	$7,000,000	June 1983			Residential	
Plumtree Associates	600,000	Oct. 6, 1981	Oct. 5, 1982	Nov. 19, 1982	Office and commercial	106
KRG Investments	7,600,000	June 11, 1982	Oct. 26, 1982	Dec. 3, 1982	Office	80
J. Investors	1,000,000	June 11, 1982	Nov. 22, 1982	Dec. 16, 1982	Office and commercial	5
Marquette Associates	3,700,000	Jan. 26, 1982	Nov. 9, 1982	Dec. 31, 1982	Office	145
E & R XII	3,375,000	Nov. 9, 1982	Dec. 15, 1982	Dec. 27, 1982		119
Calhoun Square	10,000,000	Dec. 20, 1979	Dec 7, 1982	Dec. 30, 1982	Commercial	260
808 Nicollet Mall Associates.	5,500,000	May 19, 1982	Dec. 1, 1982	Jan. 31, 1983		250
Itasca Mercantile Center	3,450,000	Dec. 7, 1982	Feb. 16, 1983	Feb. 24, 1983		150
Riverfront Square	5,175,000	Jan. 26, 1982			Office and commercial	180
Hotel St. Anthony	8,800,000	Aug. 10, 1982			Hotel	100
International Market Square East.	9,900,000	Nov. 24, 1982		August 1983	Design center and furniture mart, 457,000 sq. ft. total E & W.	228
International Market Square West.	9,900,000	Nov. 24, 1982		August 1983	Do	228
Armory Project	10,000,000	Summer, 1983				
Minneapolis Vo-Tech	10,000,000	Late 1983				
So. Nicollet Mall	10,000,000	1984				
Entire Mill District (several projects).	50,000,000	1983–86				

NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES,
Washington, D.C., June 22, 1983.

To: Members of the Committee on Ways and Means.
From: The Higher Education Community.
Re: H.R. 3110, The Governmental Leasing Act of 1983.

Attached is a copy of the statement of the National Association of Independent Colleges and Universities and the American Council on Education, as well as the undersigned groups, on H.R. 3110, the Governmental Leasing Act of 1983.

As we stress in our statement, the higher education community is very concerned about the speed with which this legislation is moving. We strongly suggest that Congress take time in order to ensure that all those involved are treated fairly. Therefore, we recommend that Congress maintain the May 23, 1983 cutoff date for sale-leaseback transactions by imposing a moratorium on all such transactions until Congress has time to consider the issue thoughtfully. We ask that Congress impose such a moratorium for a period of several months so that the higher education community, as well as other tax-exempt entities, can ascertain the full impact of the legislation.

Thank you for your time and consideration. Any questions or comments may be directed to Kathy Curry at the National Association of Independent Colleges and Universities.

This letter and the attached statement are presented on behalf of: American Association of Community and Junior Colleges, American Association of State Colleges and Universities; American Council on Education, Association of Jesuit Colleges and Universities, Council of Independent Colleges, National Association of College and University Business Officers, National Association of Independent Colleges and Universities, National Association of Schools and Colleges of the United Methodist Church, National Association of State Universities and Land Grant Colleges.

STATEMENT OF THE NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES AND THE AMERICAN COUNCIL ON EDUCATION

The National Association of Independent Colleges and Universities (NAICU) and the American Council on Education (ACE) together represent more than 1500 public and independent colleges and universities across the country. Both memberships include institutions of higher education whose variety in size, control, and mission exemplify the rich diversity of both the public and private independent non-profit sector.

In recent years, colleges and universities have experienced financial problems. Cyclical enrollment declines, increased costs, and declining federal support have combined to create fiscal difficulties for many institutions of higher education. In an effort to keep their financial situation on a steady course, colleges have attempted to develop appropriate new methods of financing higher education and of reducing operating costs. Colleges view these measures as necessary to fulfill their responsibility to ensure continued access and choice for those who wish to pursue higher education.

Historically, the federal government has assisted higher education through direct grant and loan programs, and also has recognized the public purpose activities of colleges and universities through the tax code. Although indirect, this latter recognition—specifically in the form of exemption from federal income taxation and deductibility for charitable contributions—has perhaps been as important as direct programs. In providing both direct and indirect recognition, Congress has evidenced its belief that institutions of higher education serve an important public purpose. That purpose, it is important to note, has economic as well as social dimensions. America's colleges and universities provide not only a more enlightened citizenry, vital though that function is; they also train America's managers, engineers, technicians, scientists, artists, skilled labor, and other professionals; conduct much of America's basic and applied research; and are the source of much of the creativity necessary to economic growth. In short, even though colleges and universities are not in the narrow sense taxable, profit-making enterprises, the "investment in human capital" represented by funds made available to these institutions ultimately does generate economic growth and, thus, tax revenues. In addition, colleges and universities serve as one of the largest, if not the largest, employers in many communities, thus generating further economic growth.

Accordingly, NAICU and ACE would express disagreement with the general proposition that tax incentives intended to encourage investment or otherwise stimulate economic growth should not be utilized in a manner benefiting colleges and universities.

NAICU and ACE recognize, however, that instances may exist in which transactions that are beneficial to colleges and universities may, nonetheless, be viewed as inconsistent with sound tax policy. The provisions of H.R. 3110 affecting tax-exempt organizations such as colleges and universities appear to be motivated by a concern that specific transactions engaged in or under consideration by particular institutions may fall into this category. Thus, in introducing H.R. 3110 on May 24, 1983, Representative Pickle noted several examples of transactions which he believes to be undesirable. The examples include one university's proposal to sell its basketball arenas to private investors and then rent them for university use, a college's proposed sale and leaseback of "its entire campus," and local government sale and leasebacks of existing buildings. While NAICU and ACE are sympathetic to the financial problems that make transactions of this sort attractive to educational institutions as well as local governments, we find it difficult to disagree that sales and leasebacks of existing buildings should be curbed where the transaction serves no purpose other than the generation of tax savings shared in part with the institution. Such transactions may produce additional dollars for the exempt institution, but they do not directly further its productive function. Nor do they necessarily further the Congressional purpose that was evident in enactment of the accelerated cost recovery system (ACRS) of augmenting the nation's stock of capital assets.

We believe that as presently drafted, however, H.R. 3110 would penalize higher education institutions engaging in transactions that are qualitatively different from those prompting this proposed legislation.

The bill would generally require a lessor of equipment use by a tax-exempt organization to depreciate the equipment for tax purposes on a straight-line basis over an extended period (5 years for 3-years ACRS property and 12 years for 5-year ACRS property). For example, a computer leased to an educational institution would, under the bill, have to be depreciated by the lessor on a straight-line basis over 12 years. In contrast, ACRS provides accelerated recovery over a 5-year period. Moreover, even under the tax law as in effect prior to the enactment of ACRS, the lessor could have depreciated the computer over a 5-year period utilizing acclerated methods of depreciation. The bill's proposed substantial extension of the lessor's recovery period and disallowance of accelerated methods would, of course, increase the rent charged to the institution under a lease. In some instances, the increase in rents above those charged taxable lessees could make leasing prohibitively expensive for colleges. At the same time, leasing rather than purchasing computers and other equipment may be regarded as desirable by institutions for a variety of reasons—e.g. by institutions which are hard-pressed for funds but have a need for such equipment, by those which prefer not to take the risk inherent in ownership that the equipment may quickly become technologically obsolete, or by those which simply will not need the equipment for its entire useful life. NAICU and ACE see no substantial justification for treating these transactions in a manner that is even more unfavorable than the treatment accorded them prior to the enactment of ACRS.

With respect to real property used by a tax-exempt entity, H.R. 3110 would require straight-line depreciation over 35 years rather than ACRS over 15 years. These provisions may apply to real property if: it is financed in whole or in part with tax-exempt bonds and the institution or a "related entity" participated in the financing; if it is leased to an institution under an agreement containing a fixed price purchase or sale option or under which the institution "directly or indirectly protects the lessor from loss of his investment in the property"; or if the institution sells or leases the property and then leases it back. These provisions would not apply, however, unless more than 20 percent of the use of the property consisted of use by the institution. (The bill does not specify how such "use" is to be measured.) A separate provision of the bill would disallow the rehabilitation tax credit where either the rehabilitation expenditure or the building has been financed by tax-exempt industrial development bonds.

In the brief period that has elasped since the introduction of H.R. 3110, NAICU and ACE have not been able to develop complete information as to the potential impact of these complex and somewhat ambiguous provisions on their more than 1500 member institutions. Based on the limited information available, however, it appears that the bill would adversely affect certain types of worthwhile transactions illustrated by the following examples:

College A, which is located in a small community, needs to have available new lodging for college visitors and meeting rooms for conferences. It does not, however, have the capital to build such a structure nor does it particularly desire to enter the hotel business. Accordingly, College A leases land at the edge of its campus to a private developer under a ground lease providing for rentals that are in part a function of the gross receipts of the hotel to be constructed. The college anticipates that it will make substantial (perhaps more than 20 percent) use of the hotel. While we believe that H.R. 3110 would not affect transactions of this type, the "lease-leaseback," "no protection of investor," and other provisions of the bill leave the result less than clear. Ground lease arrangements for the development of hotels, shopping centers, office buildings, or apartment complexes on land owned by colleges and universities have always been regarded as appropriate activities. NAICU and ACE believe it important that H.R. 3110 be revised to make it clear that the provisions of the bill do not apply to such arrangements, even though the institution may at some point make some use of the facility constructed on leased land for conferences, offices, classrooms or student or faculty housing.

(2) College B has an administration building, parts of which are 40 years old and parts of which are 60 years old. The building is in need of rehabilitation at a cost of $3.4 million. By entering into a proposed sale and leaseback transaction with a taxable corporation which would utilize the rehabilitation credit and ACRS deductions, the college would reduce this cost by an estimated $350,000. (If the rehabilitation could be financed through tax-exempt bond financing, the college could realize additional savings.) The 35-year straight-line recovery period (and the inability to utilize tax-exempt bond financing), which would result from H.R. 3110, would have a substantial adverse impact on this transaction since the financing might no longer be feasible.

(3) College C, an urban university, has several high-rise dormitories which it proposes to sell to a limited partnership. The limited partnership will substantially ren-

ovate the buildings and lease them back to College C at fair rental value. This transaction is clearly adversely affected by H.R. 3110, and probably would not go forward if the bill is enacted.

(4) College D, a state university, proposes to lease student housing from a taxable corporation which will construct such housing with funds provided by tax-exempt bond financing. The lease will be at fair rental value, the university will have no fixed price purchase option and will not indemnify the corporation against losses. The housing could be converted by the corporation to an apartment complex at the end of the lease term. H.R. 3110 would appear to adversely affect this transaction.

Unlike the examples cited in support of H.R. 3110, each transaction of the sort described above involves a new expenditure of funds for a capital asset. NAICU and ACE believe that in these circumstances the capital formation purposes underlying ACRS are served. Moreover, the new construction or rehabilitation expenditures involved in these transactions directly produce taxable revenues. The capital assets themselves, by furthering the institution's performance of its economic role, should ultimately enhance economic growth. Finally, it should be noted that in one respect, leases to tax-exempt entities have a more favorable impact on federal revenues than do leases to taxable entities. In a lease to a taxable entity, the rental income to the lessor produces a corresponding rental deduction to the lessee. Where the lessee is tax-exempt, however, the lessor has rental income but the rental deduction produces no additional revenue loss. H.R. 3110, however, generally fails to distinguish productive transactions from unproductive ones.

One example of H.R. 3110's failure to draw appropriate distinctions is its treatment of older college buildings sold to a private developer at fair market value, renovated by the developer, and then leased back to the college at a fair rental value. In the Economic Recovery Tax Act (ERTA) of 1981, Congress specifically provided that the increased credit for "qualified rehabilitation expenditures" on older buildings and historic structures should be available, to the extent of basis attributable to such expenditures, with respect to properties used by tax-exempt entities. In doing so, Congress recognized that application of the general disallowance of "the investment credit for property leased to tax-exempt organizations and governments [would] operate to significantly impair Congressional intent to encourage the rehabilitation of older structures." [1] Thus, in ERTA, Congress correctly recognized that the public policy favoring rehabilitation of older and historic buildings is served in equal measure whether the buildings are used by tax-exempt or taxable entities.

H.R. 3110, however, runs counter to the policy recognized in ERTA. The only manner in which the rehabilitation credit can be utilized to encourage renovation of older and historic properties owned and used by colleges and universities is through a sale to a taxable entity, rehabilitation by the entity, and a subsequent leaseback of the properties. As presently drafted, H.R. 3110 would require the taxable purchaser-lessor in such a transaction to deduct its rehabilitation expenditures on a straight-line method over a 35-year period, rather than under ACRS over 15 years. This result is produced by the bill's inclusion of all sales and leasebacks, without regard to their economic substance or objectives, within the definition of "tax-exempt use" real property. This denial of ACRS benefits with respect to qualified rehabilitation expenditures is, we submit, plainly unjustified and contrary to the ERTA policy of making rehabilitation incentives equally available to property used by tax-exempt organizations.

To summarize, NAICU and ACE believe that economically productive transactions logically can and should be distinguished from the sterile transactions, in and of themselves productive of nothing but tax benefits, motivating the provisions of H.R. 3110 applicable to colleges and universities. If, for example, the tax benefits that H.R. 3110 proposes to disallow were, in the case of colleges and universities, allowed only with respect to new property or, for substantial rehabilitation to the extent of the rehabilitation expenditures, both the transactions perceived as abusive and any threat to tax revenues posed by potential sale and leasebacks of the existing stock of college and university property would be eliminated. We believe that such an approach is clearly preferable to one which, in response to transactions motivated largely by ACRS benefits, would in many instances place colleges and universities in a worse position than that which obtained prior to the enactment of ACRS.

In closing, NAICU and ACE wish to emphasize that the unusually short period thus far allowed for analysis of this proposed legislation and its potential effects leaves us with great concern that neither those who would be affected, the Administration, nor the members of Congress have an adequate assessment of its potential impacts. In considering this legislation, Congress is discussing substantial changes in current law. We ask that Congress take its time in order to ensure that all those involved are treated fairly and in good faith. We believe that a solution to the problems raised by these transactions must be carefully crafted to avoid unnecessary and unsound impacts on legitimate, traditional transactions engaged in by colleges and universities, and other tax-exempt organizations. If immediate legislative action is viewed as necessary, it should be narrowly targeted at unproductive, purely tax-motivated transactions and leave for more careful consideration the desirability of further restricting generally available tax benefits simply because a tax-exempt organization uses property to which those benefits relate.

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[1] Report of the House Committee on Ways and Means on H.R. 7956, the Miscellaneous Revenue Act of 1980, Sept. 4, 1980, p. 21. H.R. 7956 contained the rehabilitation expenditure changes utlimately adopted in ERTA.

NATIONAL HYDROPOWER ASSOCIATION,
Washington, D.C., June 10, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: This letter is submitted for inclusion in the record of the hearings on H.R. 3110, the Governmental Leasing Tax Act of 1983, on behalf of several trade associations and other organizations which represent members of the renewable energy and cogeneration industries, including the American Wind Energy Association, the Cogeneration Coalition, the International Cogeneration Society the National Hydropower Association, the Renewable Energy Institute, the Solar Energy Industries Association, and the Solar Lobby. These organizations strongly endorse the efforts of this committee to curb tax abuses arising out of leasing arrangements between taxable entities and tax-exempt organizations. However, there is one provision in the bill which has already generated considerable concern within the rewable energy and cogeneration industries. That provision concerns the classification of service contracts as leases for purposes of present restrictions on the investment credit and proposed restrictions on the availability of ACRS deductions.

Tax-exempt organizations and governmental organizations are substantial consumers of electrical and thermal energy. As such, they are well suited to take advantage of the energy alternatives presented by renewable energy and cogeneration systems. Potential customers for the output of such systems range from hospitals, which can use the thermal energy produced by cogeneration or solar systems; to municipal electric utilities and rural electric cooperatives which can use the electricity produced by cogenerators, windfarms, and hydroelectric plants.

Currently, property leased to a governmental unit or tax-exempt organization is ineligible for the investment and energy tax credits. Moreover, the IRS has long taken the position that service contracts which more closely resemble leases than actual service contracts in substance should be classified as leases for purposes of this rule. However, both the IRS and the courts have also recognized that property used to provide a service to a governmental unit or a tax-exempt organization under a legitimate service contract should remain eligible for the tax credits. This distinction is based on sound public and tax policy considerations, since there is no reason why legitimate, tax paying service related businesses should be treated differently merely because their customers are tax-exempt, as opposed to taxable, entities. The IRS has applied a variety of criteria, including control over use of the property, right to possession of the property, and risk of loss with respect to the property, in distinguishing service contracts from leases.

One section of H.R. 3110 would amend the Internal Revenue Code to specify that a contract which purports to be a service contract, but which more closely resembles a lease, will be treated as a lease for purposes of determining eligibility for the credits. This provision indicates that the determination of whether a lease more closely resembles a service contract is to be based on all of the facts and circumstances, including whether the user has control over the property and whether the user has a signficant possessory or economic interest in the property.

This proposal has generated considerable confusion and uncertainty within the renewable energy and cogeneration industries. In particular, energy project developers have been unable to tell whether this version is intended to give Congressional approval to the existing criteria, or is intended to alter those criteria in a manner which would make it more difficult for a contractual arrangement between a private energy supplier and a governmental entity to tax-exempt organization to be classified as a service contract for tax purposes. This, in turn, has had a substantial chilling effect on projects whose output will be sold to governmental units or tax-exempt organizations.

We urge this committee to clarify that H.R. 3110 is intended to reaffirm, and not to alter, the criteria applied under current law to distinguished service contracts from leases. These criteria provide the IRS with adequate means to distinguish legitimate service contracts from leases. At the same time, they have created a set of standards which allow renewable energy and cogeneration project developers to enter into contractual arrangements with tax-exempt organizations and governmental units with reasonable certainty as to their classification for tax purposes. Any change in these criteria could make it much more difficult for renewable energy and congeneration project developers to work with tax-exempt or governmental entities. Because that could cost the country the benefit of the substantial energy savings which could be realized from the governmental and tax-exempt sectors, it would be an unfortunate result not only for the renewable energy and cogeneration industries, but for the entire country.

Respectfully submitted.

LEE M. GOODWIN,
Vice President and General Counsel.

STATEMENT OF E. WAYNE THEVENOT, PRESIDENT, NATIONAL REALTY COMMITTEE

I. THE NATIONAL REALTY COMMITTEE

National Realty Committee, Inc. is a non-profit business league whose membership includes owners, operators, financiers, and developers of all types of real estate throughout the United States.

The National Realty Committee respectfully submits the following comments with respect to H.R. 3110.

II. IN GENERAL

Enactment of H.R. 3110 would have far-reaching effects on a broad range of potential transactions involving both real and personal property. The policy underlying the proposed legislation is stated to be the denial of tax incentives for property used by governmental agencies and other tax exempt entities. Yet the public policy issues involved clearly include the sharing of social costs among various levels and agencies of government and the degree of Federal encouragement to be extended to non-profit institutions. Since the operative provisions of the proposal directly affect private taxpayers (and only indirectly affect the tax exempt entities), enactment of the proposals would necessarily also affect economic activity and employment. The National Realty Committee therefore believes that the underlying issues involved deserve substantial attention and study.

We are aware of the hearings held by the Subcommittee on Oversight on February 28, 1983, which focused primarily on lease/charter arrangements entered into by the Department of the Navy for certain ships. We caution that government policy with respect to naval vessels may not, for many reasons, be necessarily applicable to privately owned hospitals, educational institutions and other structures used in whole or in part by tax exempt entities for socially desirable, public purposes.

With respect to the findings and recommendations of the Subcommittee on Oversight, we support the statements concerning the need for increased analysis of the total costs of long-term government leasing programs. However, we must point out that the Subcommittee's apparent finding that long-term leasing of major assets is more costly to the federal government than purchase of the same assets was based upon an analysis which apparently presumes the interchangeability of private sector funds between purchase of assets leased to tax exempt entities and the federal bond market, an analysis open to some doubt.

We also note that the recommendation that Congress should consider limiting cost recovery deductions for property leased to nontaxable entities "so that the tax system does not make leasing more attractive to these entities than direct ownership" has a necessary corollary: that potential lessors of property will find that the tax system makes leasing to a nontaxable entity less attractive than leasing such property to any other entity: Enactment of the recommendation, therefore, would have the effect of penalizing both taxable lessors and tax exempt lessees. For example, a leaseback transaction with a taxable entity which, by reason of lack of income or net operating losses, is paying no tax would be treated differently from a similar transaction with a tax exempt entity, even though many tax exempt entities would have no taxable income without reference to their exempt status.

We would also note that the rent received by the lessor is taxable to the lessor in the same manner whether received from a taxable entity or a tax exempt entity despite the obvious fact that the deduction for rent paid is not meaningful to a tax exempt entity.

For the foregoing reasons, we believe that H.R. 3110 deserves careful study and an opportunity for wide public comment prior to any enactment and that the proper scope of any bill directed towards the problems covered by H.R. 3110 should be carefully delineated.

III. SPECIFIC COMMENTS

With respect to specific provisions contained in H.R. 3110:

A. Scope of provision

Proposed Code section 168(f)(13)(C)(ii) defines "tax exempt use property" in the case of 15-year real property to include any one of four categories of property to the extent used by a tax-exempt entity: (I) property financed to any degree by tax exempt obligations where the tax exempt user (or a related entity) participated in such financing; (II) property the use of which is pursuant to a lease providing a fixed price purchase option to the tax exempt user (or a related entity); (III) leased property where the lessor is protected against loss on his investment by the tax exempt user (or a related entity); (IV) property the use of which occurs after a sale-leaseback with the tax exempt user (or a related entity).

We believe that the policy considerations involved in applying the suggested rules of proposed Code section 168(f)(13)(A) to each of the foregoing categories of use differ. For example, in our view category (I) involves issues more properly relating to the use of industrial development bond financing generally and we would, therefore, recommend deletion of subclause (I) of proposed Code section 168(f)(13)(C)(ii) (see paragraph E below).

Similarly, category (II) may or may not, depending upon the facts, involve questions as to the true nature of the transaction as a lease or a sale, an issue which in our view need not be dealt with in this legislation. Where the facts and circumstances indicate a true lease transaction despite the fixed tests of category (III) or (IV) are not satisfied, should not of itself result in the imposition of the proposed ACRS restrictions.

With reference to categories (III) and (IV) we believe that neither, without the other, should be considered sufficient to warrent consideration for application of the proposed restrictions. A net lease, without a sale-leaseback or a sale-leaseback, without a net lease, do not, in and of themselves, seem to us to necessarily involve the kinds of transactions which probably motivate much of the concern giving rise to the proposed legislation.

We are therefore of the view that if legislation embodying the concepts contained in proposed Code section 168(f)(13)(A) is to be enacted, such limitations should apply only where the conditions set forth in subclauses (III) and (IV) of proposed Code section 168(f)(13)(C)(ii) are both satisfied.

B. Recovery period

To the extent the restrictive rules of H.R. 3110 are determined to be applicable to 15-year real property, we believe that the appropriate treatment is not to apply a 35-year recovery period which may be clearly inapposite in any particular situation, but to treat such property as not "recovery property" thereby eliminating any ACRS benefit and permitting the utilization of depreciation based upon economic useful life as determined under Code section 167. Where, for example, a leaseback of property is for a fixed term of 20 years and the lessor has no certainty with respect to any extension of renewal, extending the lessor's recovery period with respect to its investment in the property from 15 years to 35 years because the lessee is a government agency or other tax exempt entity appears to impose an excessive penalty on the lessor. Simply denying the availability of ACRS benefits would provide treatment similar to that currently provided under the so-called anti-churning rules of Code section 168(e)(4).

C. Clarification of terms

The reference to "a casual or short-term lease" under proposed Code section 168(f)(13)(C)(i)(II), the reference to "a related entity" in proposed Code section 168(f)(13)(C)(ii) and the provisions respecting the treatment of certain contracts for providing services in proposed Code section 168(f)(13)(E) require clarification.

D. Effective date

The effective dates contained in subsection (d) of section 1 of H.R. 3110 do not appropriately reflect the legitimacy of taxpayers' reliance upon existing law in the conduct of their businesses. The policy matters dealt with by H.R. 3110 are important and involve substantive issues which, as indicated above, National Realty Committee believes should be subject to consideration study and comment. Sale-leaseback transactions with governmental agencies and tax exempt entities usually involve substantial sums, considerable complexity and often long periods of negotiation. Whatever the view may be concerning the proper treatment of such transactions in the future, in our view such transactions do not constitute abusive tax shelters requiring legislative correction to a date preceding enactment.

We believe therefore that the May 23, 1983 date should be replaced with a future date which would permit the consummation under existing law of transactions in which many parties have invested substantial time and money in good faith reliance upon existing law.

Furthermore, we believe that the provision currently contained in section I(d)(2)(A) of the Bill for grandfathering transactions resulting from written binding contracts with "the taxpayer (or his predecessor in interest under the contract)" is much too limited. Where the requisite binding written contracts currently exist, all successors to the lessor's interest in the property should be grandfathered, not merely successors to an "interest under the contract." Moreover, we believe that any purchaser of the lessor's interest in a sale-leaseback transaction which was or is consummated prior to the effective date of any new legislation should not be adversely affected by such legislation. Therefore, any new rules should be limited to situations where the first use by the tax exempt entity occurs after the effective date; otherwise all currently existing owners of properties which have been leased back to governmental agencies and tax exempt entities will find the marketability of their interests severely limited and the value of their interests thereby unfairly reduced.

E. Rehabilitation credit

We believe that the provisions of subsection (c) section 1 of H.R. 3110 dealing with the rehabilitation credit should not be part of this legislation. The issues involved in this provision relate generally to another set of considerations which are currently the subject of separate consideration and study in connection with legislation dealing with industrial development bonds generally.

In addition, the provisions contained in proposed Code section 48(g)(2)(vi) disallowing the entire credit if "any portion" of the cost of the building of rehabilitation is financed with industrial development bonds is excessively severe. In any event, the credit should only be limited "to the extent" that rehabilitation costs (and not otherwise non-creditable building costs) are financed by the proceeds of industrial development bonds. Compare Code section 168(f)(12)(A).

Respectfully submitted.

E. Wayne Thevenot, *President.*

National Trust for Historic Preservation,
Washington, D.C., June 15, 1983.

Re H.R. 3110: Impact of the Governmental Leasing Act on Historic Properties.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Mr. Chairman: The National Trust for Historic Preservation wishes to express its opposition to elements of the proposed Governmental Leasing Act as drafted and to request a critical change in the bill to benefit the preservation of historic properties. While we share the Committee's concern for the abuses which H.R. 3110 seeks to redress, we believe that the legislation will have unintended, adverse consequences for the protection of historic properties. Based upon our experience and research described below, we believe that Section 1(c), which makes the rehabilitation credit and tax exempt industrial development bond (IDB) financing mutually exclusive, should be deleted from the bill.

Section 1(c) is unrelated to the problems, the bill is purported to address and, in conflict with Congressman Pickle's explanation of the bill, it applies beyond buildings leased to tax-exempt entities to all rehabilitated buildings. Most importantly for historic preservation and urban revitalization efforts, Section 1(c) will undermine significant commerical and housing rehabilitation projects in the socially and economically distressed areas that these incentives are intended to benefit. Without assistance in the building's rehabilitation through the investment credit, and then assistance in post-rehabilitation operations through the cheaper financing provided by an IDB, many of these worthy but high risk projects will fail.

The evidence we have about the rehabilitation market, the types of projects being encouraged and the often critical element of IDB financing makes a compelling case for deletion of Section 1(c).

The National Trust's study of the impact of federal tax laws on the preservation of America's heritage (completed in the spring of this year) found, contrary to the generally held assumption, that it is not the large developer, but rather private individuals or relatively small partnerships with gross incomes under $100,000 who are using the rehabilitation incentives. They generally undertake less than one building project a year. Our research confirmed Department of the Interior statistics that one of every two historic rehabilitation projects would not have been possible if it were not for the existence of the targeted historic preservation tax incentives. Thus, loss of the rehabilitation credit potentially could eliminate as many as half of future projects.

Following the factor of location, developers report that the cost and availability of financing is the most important consideration when undertaking a construction project. Financing the renovation of older and historic properties suffers from inherent disadvantages in the competition for scarce investment resources: physical deterioration and often economic and functional obsolescence. Moreover, older property rehabilitations were perceived to be more difficult as to predictability of construction costs, more difficult to execute and more expensive to operate. These perceptions influence the willingness of lenders to find rehabilitations.

Not surprisingly then, 50 percent of those surveyed in the Trust study considered new construction to be best in terms of the ability to obtain financing; only 14 percent felt that financing would be more readily available for a historic rehabilitation. The perception and reality of this financing handicap for older and historic properties emphasizes the importance of IDB assistance to these projects. Significantly, 21 percent of the users of preservation tax incentives reported that they had used IDB financing as a source of funding for their projects.

The National Park Service has noted that investment in historic rehabilitation projects certified for the tax incentives has totaled $2.98 billion in the six years since the existence of the tax incentives. Approximately one-third of that investment as certified in 1982, indicating a growing interest in and commitment to restoration of our nation's building stock. Significantly, about half of these projects involve rehabilitation of a total of 39,197 housing units nationwide, 23,005 of which are newly created units. Over one-third, or 12,392, involve housing for low and moderate-income families. It is these projects that need the most public assistance.

Our own firsthand experience through the Trust's Inner-City Ventures Fund and the National Main Street Center confirms that the success of many local projects is due to the ability to combine a number of funding options.

Two projects in Massachusetts, assisted through the Inner-City Ventures Fund, are particular examples of this. The first, in Springfield, is a joint venture of the Brentwood Development Corporation, a neighborhood-based group, to save and reuse an historic parish hall located within the Memorial Square Historic District. The hall will be converted to a much needed neighborhood medical building to provide office space and examining facilities for doctors from an expanding state hospital. Of the total project cost of $1.35 million, $300,000 will be contributed by private investors eligible for the rehabilitation tax credit; $900,000 will be raised through the issuance of a state-financed industrial development bond, and the remaining $150,000 will come from both public and private sources, including National Trust grants and loans. Ultimately, four of the seven buildings in the district will be rehabilitated with the Trust's assistance, including the rehabilitation of a 40-unit apartment building for continued low-income rental use and the reuse of two buildings for commercial and community-oriented uses.

In Jamaica Plain, 16 largely vacant buildings of an old brewery are being purchased using federal, Trust, and other monies, and renovated for small business and light industrial use. In the first phase of this staged project, 100 new jobs will be created in this low-income neighborhood. The next phase of the program, during which the renovation of some of the larger buildings in the complex will take place, is contingent on the availability of industrial development bond financing and additional private investment stimulated by the rehabilitation tax credit.

Similarly, a range of projects being assisted by our National Main Street Center use a variety of financing alternatives to encourage the renovation and economic redevelopment of historic downtowns. Currently operating in 63 towns and cities in the states of Colorado, Georgia Massachusetts, North Carolina, Pennsylvaina and Texas, the Center anticipates adding four to five states next year. In the State of Georgia alone, a sampling of community development projects in large urban areas, including Atlanta, and small scale main street renovation efforts found 17 projects, worth $110.65 million and creating from 2,955 to 3,456 jobs, will use both the rehabilitation credit and IDB funding mechanisms.

Several main street projects in Grand Junction, Colorado, for example, require the advantage of both the rehabilitation credit and industrial development bond financing. The adaptive reuse of a public school building, constructed in 1920, is planned to house the Museum of Western Colorado, which would otherwise have left the historic downtown for a new building in the suburbs. The school will be bought by a limited partnership, in combination with a non-profit general partner, renovated and sold to the Museum under a 15-year lease-purchase arrangement. It is, in addition , anticipated that the most significant building in the historic downtown, the First National Bank of Grand Junction, will be saved through the use of the 25 percent preservation credit and tax-exempt financing. Although initially deciding to demolish the old headquarters in favor of a new bank building two blocks away, the president of the bank has agreed to present a plan to his board of directors to occupy the building for an additional year, seek its listing on the National Register of Historic Places, and then sell it to a new owner who presumably, would take the 25 percent investment tax credit and seek tax-exempt financing of the ultimate restoration.

These are only a few examples of the kind of energetic planning and activity being undertaken across the nation for the preservation of older and historic buildings. The importance of both the rehabilitation credit and beneficial financing to many of these projects leads the National Trust to request the deletion of proposed Section 1(c). In the event the Committee does include some proscription in the bill, it is essential in all fairness to ongoing projects to include a transition rule sufficiently broad to protect projects initiated in reliance on existing law.

We hope that the Congress will reaffirm in H.R. 3110 its commitment to the preservation of the nation's older and historic resources. Please continue to call on us if we can be of assistance in your deliberations.

Sincerely,

MICHAEL L. AINSLIE, *President.*

NORTHEAST MARYLAND WASTE DISPOSAL AUTHORITY,
June 6, 1983.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Ways and Means Committee,
Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: The Northeast Maryland Waste Disposal Authority is a public instrumentality of the State of Maryland charged with developing solid waste management projects on behalf of Baltimore City and Anne Arundel, Baltimore and Harford Counties. Two bills currently under Congressional consideration could seriously impede the Authority's mission of providing essential solid waste disposal facilities for use by the general public. Both H.R. 1635 and H.R. 3110 would seriously impair the Authority's ability to structure public projects which provide essential public services at the lowest cost. The Authority proposes that these bills be amended to incorporate exemptions similar to those found in Section 216 of TEFRA of public sewage and solid waste disposal facilities.

The exemption for public sewage and solid waste disposal facilities contained in TEFRA is a sensible approach to the issue. The problem with the initial drafts of bond bills is that the limitations on "private-purpose" industrial development bonds inadvertently hamstring legitimate "public purpose" tax-exempt financings. After a comprehensive review of tax-exempt financing, Congress passed TEFRA which recognized that bonds for public sewage and solid waste disposal facilities really constituted public tax-exempt financing and should not be subject to the limitations on private purpose industrial development bonds. The function of providing solid waste disposal services had traditionally been a municipal function. The costs of disposing of waste generated by the general public are paid for by the public through taxes, user fees or other mechanisms. As landfill space becomes scarcer and the environmental problems associated with burying solid waste are recognized, the need for capital intensive resource recovery facilities is becoming more acute. Consequently, it is very important that the mechanism for raising capital for these public projects not be cut off when the need is greatest. The Authority believes that the public policy recognized by Congress last fall should continue.

There is no comparison between the project evaluations which the Authority undertakes and those which sometimes precede the issuance of private purpose IDBs. The Authority as a matter of policy has determined that the involvement of the private sector on a long-term basis is the best way of implementing a resource recovery project. It provides the surest safeguard against the technical problems which have beset many resource recovery projects. The involvement of a private sector vendor is accomplished through a public procurement process and extensive negotiations which often take many months. Each project is subject to rigorous economic analysis which assures that the tax benefits associated with private ownership are passed through to the public in determining the pricing mechanism for waste disposal. The Authority undertakes this analysis on behalf of its constituent political subdivisions which area paying for these services.

It was only two years ago that the Baltimore Metropolitan area faced a severe solid waste management crisis. The Authority, in cooperation with the participating subdivisions, through the financing of a 2,000 ton per day resource recovery facility has implemented a key component in a system which will provide environmentally safe and economical solid waste disposal for the next forty years and beyond. The facility is privately owned and operated but makes available to the public waste disposal services both through long-term contracts with Baltimore City and Baltimore County and additional capacity which will be available for waste generated by the general public that local governments do not collect. Without the ability to issue tax-exempt revenue bonds for this facility and to negotiate a fair price for waste disposal services which take into account the tax benefits associated with private ownership, the Authority's efforts would have ended in failure. The Authority is in the process of implementing resource recovery projects for Harford County and Anne Arundel County which would benefit from these considerations.

The Authority urges you and your committee to support the continued availability of tax-exempt financing and the current tax benefits incentives for public solid waste management purposes.

Thank you for your consideration of our position on these two bills.

Sincerely,

ROBERT F. SCHOENHOFER,
Executive Director.

STATEMENT OF RODNEY D. JOHNSON, MANAGING DIRECTOR, CITY OF PHILADELPHIA

Mr. Chairman and Members of the Committee, I am Rodney D. Johnson. As the Managing Director and former Director of Finance for the City of Philadelphia, Pennsylvania, my responsibilities include capital budgeting, all of the city's debt financing, and financing of public and joint public-private development projects, including projects that make use of the leasing and financing opportunities created by the Economic Recovery Tax Act of 1981 ("ERTA").

I. PHILADELPHIA'S ECONOMIC DEVELOPMENT EFFORTS

The City of Philadelphia has many problems typical of aging Northeastern United States cities. The city's population and economic base and, hence, its tax base have shrunk. Yet, it must serve its citizens who include a disproportionate number of the age and poor who are heavily dependent on city services. At the same time, the city's major capital assets—roads, transit system, water and sewer system, port facilities, airports, prisons, and utilities—are aging rapidly and require major maintenance expenditures or substantial new investment.

Much of this investment and other funding comes from traditional private and government sources. Utilizing these sources, the city is attempting to rebuild its economic base with projects such as Penn's Landing, a major commercial and residential development on the downtown waterfront, estimated to generate 3,650 jobs; Market East, the redevelopment of twelve blocks of downtown Philadelphia into a major retail, office, and transportation center, including the precedent-setting urban shopping malls, Gallery I and Gallery II, with 3,825 direct jobs and 3,442 indirect jobs; and the Center City Commuter Tunnel, which will link the two major commuter rail systems in the center of the city, generating 1,590 construction jobs. Innumerable smaller projects are underway in the city's neighborhoods and commercial strips. The city is also currently in the planning phase of a new convention center which will directly generate an estimated 9,000 new jobs. It is our expectation that these projects, along with improvements to our infrastructure systems, will revitalize the city.

II. INSTITUTIONAL AND LEGAL LIMITATIONS ON PHILADELPHIA'S CAPITAL INVESTMENT EFFORTS

The underlying limitation on our ability to carry these projects, which represent anchors for economic growth, on-stream, the city must attract private and public sector investment. Yet, just when our need is greatest, we find the supply of funds diminishing and the cost increasing.

There is no need to describe in detail the rise in interest rates which hamper the city's ability to borrow. Even with the relief of recent rate declines, we find the cost of borrowing is nearly double that of ten or fifteen years ago. Further, the looming federal deficits are anticipated to drive the demand for credit and interest rates to new all-time highs.

The city also faces a statutory debt limit imposed by the Constitution of the Commonwealth of Pennsylvania. Thus, even if the city could afford to borrow at any interest rate, it is limited to a fixed amount of general obligation bond financing outstanding at any one time. This cap is currently $60 million.

Finally, federal funding has been a useful and valuable supplement to the city's direct investment. We are grateful for such funding which has helped finance our airports, roads, transit system, water and sewer system, housing, and economic development projects. Yet, again, when our need is greatest, we see the federal government cutting back on its commitment to share in the necessary costs of maintaining a viable and livable metropolitan area.

III. IMPORTANCE TO PHILADELPHIA OF FINANCING OPPORTUNITIES CREATED BY ECONOMIC RECOVERY TAX ACT OF 1981 AND DESCRIPTION OF CERTAIN KEY PROJECTS UTILIZING TAX INCENTIVES

One of the last remaining available sources of capital has been the private sector. Some of the aforementioned major development projects were only possible due to close working relationships with, and direct contributions by, private corporations. These investments do not come from a sense of charity, or solely from a public commitment to urban development by private industry. Instead, they are made because they offer a fair and competitive return.

One of the factors that make such critically needed investments attractive in the highly competitive money market is the leasing and financing opportunities created by the Economic Recovery Tax Act of 1981, which was welcomed by the City of Philadelphia. At a time when historical federal funding sources are either non-existent or vastly reduced, and when the city's debt capacity for such projects is exhausted, the city is now planning several essential projects necessary to its well-being, which would utilize leases between the city and private sector participants. If incentives such as the Accelerated Cost Recovery System ("ACRS"), rehabilitation tax credits, and Investment Tax Credits ("ITC") were taken away in these vital areas of public service, Philadelphia could not compete successfully for the investment dollar.

While your Committee may correctly view some of the transactions that have received so much national publicity as having little "social value" or justification, at least when compared to their cost to the U.S. Treasury, I urge you to be extremely careful not to use a meat cleaver where the application of a surgeon's knife and skill may best achieve the desired result. To paraphrase an old adage of Justice Holmes, "bad examples make bad laws".

It would be disastrously short-sighted to focus only on tax revenues lost in the short-term while losing sight of the need to rebuild our nation's economy and the substantial long-term employment, tax revenue, and general economic growth which flows from projects such as the ones I will now describe. They represent projects Philadelphia is currently planning to finance using private sector investment combined with leases to the city. They illustrate the versatility of this approach and its usefulness in helping municipalities undertake costly development efforts with sound public benefits.

The city is currently under court order to expand its prison capacity by more than 1,000 beds. To satisfy this order, the city is planning three facilities utilizing private sector investment and leases to the city. The first is a 250-bed modular prison cell project, estimated to cost $10 to $12 million. Bid documents should be ready by late summer. The second is a 400-bed conventionally constructed facility, costing approximately $25 million, on which construction will commence in late 1984. Finally, the city has initiated site acquisition for a 540-bed Center City detention facility, costing approximately $40 million. Public financing is simply not available due to our legal debt limit; yet the city's potential legal liability, as well as the human cost of overcrowded and unsafe prisons, is incalculable if these facilities are not constructed.

Another essential project that could be adversely affected by H.R. 3110 is the city's planned solid waste disposal facility. Environmental concerns, limited availability of landfill sites, and rising landfill costs, caused the city to seek a long-term solution: the construction of a mass-burn facility which will incinerate over half the trash collected by the city and thereby produce steam and electricity. Because of the enormous financing requirements of such a facility, estimated at about $250 million, and the complexity and financial risk of operating it, we chose to seek a private entrepreneur to perform these functions. This decision is not unlike numerous decisions by municipalities over the years with respect to the provision of other required services or utilities, such as electricity and water. The choice of private enterprise over municipal ownership for such activities is common and certainly not a new idea based on tax considerations.

On March 25 of this year, a Request for Qualifications was issued to vendors and discussions are now underway with the respondents. The city will enter into a long-term service contract with the selected private owner and operator in which it will guarantee delivery of a set number of tons of garbage per year and will agree to pay a negotiated tipping fee to the owner/operator for the service of incinerating and disposing of the city's waste. As in any other private business, the vendor is taking substantial risks if he fails to perform his contractual responsibilities. His profit or loss will depend upon his performance and he will pay taxes on the income he earns. There is no rationale to deny him the tax benefits of normal depreciation that would otherwise accrue to him, just because he is in a contractual relationship with the city. There is certainly no tax benefit that accrues to him just because the city is involved. The fact that the city shares some of this benefit in the same way that a for-profit entity might, should also not be a basis for denying the tax benefits. A change in tax treatment would discriminate against such vendors and add to the city's costs, thereby discouraging construction of such a facility to the detriment of sound social and environmental policies which have been recognized and acknowledged by Congress when it excluded solid waste facilities from the ACRS depreciation restrictions imposed by the Tax Equity and Fiscal Responsibility Act of 1982.

Another planned city project which is viewed as a major business generator for the city's economy, but which would be adversely affected by H.R. 3110 is our planned new convention center. We are the nation's fifth largest city but rank only twenty-second in the country in terms of our convention business. Our natural advantages of location and ambience have been cited as prime attractions to potential convention business, if we can build a first-class facility. Nine thousand new jobs would result from such a facility. We estimate the cost of the new center to be $250 million to $300 million. Although a dedicated revenue stream, such as a hotel tax or special assessment will be utilized to help finance this facility, we estimate that direct private sector investment based on the tax benefits of ownership would reduce the total capital cost by $50 to $60 million.

Finally, the city is considering the construction of a small-scale hydro-electric power project for the Schuylkill River. This project is only feasible when the revenues from power sales are combined with the tax benefits of private ownership. Without the facility, the overall cost of power to city residents will be greater.

IV. PHILADELPHIA'S PROJECTS ARE DRIVEN BY NEED—NOT BY TAX INCENTIVES

The preceding summary is not an itemization of every planned city project that would be detrimentally impacted or even made impossible by H.R. 3110 in its present form. Rather, it represents a cross-section of critical needs that the city must meet and where current tax provisions are an important component of the project's total financing package. None of these projects are motivated by the tax laws nor are any of them contemplated for the purpose of creating windfalls to private investors. To the contrary, each involves substantial risk for the private sector participants. Nor is the circumstance of cities choosing private enterprise over municipal ownership for vital public services or utilities a new phenomenon based on tax considerations first enacted in ERTA in 1981. Rather, the financing techniques are options which the city must pursue in order to raise necessary capital for sorely needed projects. The advantages of ITC or ACRS only serve to enable us to compete for funds in the open market. The city's objections to H.R. 3110 are founded solely on the facts of life faced in capital markets when we compete for a limited supply of dollars and are constrained by rising interest rates, legal debt limits, and decreased federal funding. We seek only the ability to compete effectively for our capital needs.

V. IMPORTANCE OF PHILADELPHIA'S EQUIPMENT LEASING OPTIONS

Finally, I would like to note the city's objections to the sections of H.R. 3110 pertaining to short-term and casual leases. We understand it is not the intention of this legislation to put an end to the traditional equipment leasing options which our city has utlized for over five years. However, we fear that our computer leases involving approximately $10 million of equipment will no longer be possible due to their four to seven year duration. We strongly urge that H.R. 3110 be clarified so as not to impair such leasing transactions.

VI. CONCLUSION

Thank you for this opportunity to present the City of Philadelphia's views on H.R. 3110. We urge the Ways and Means Committee to reject any legislation that will unduly restrict the ability of local governments to join with willing private investors to produce new projects with enormous economic and service benefits for their citizens.

STATEMENT OF LUCIEN B. CALHOUN, PRINCIPAL, PUBLIC FINANCIAL MANAGEMENT, INC.

INTRODUCTION

My name is Lucien B. Calhoun, I am a Principal and Director of Public Financial Management, Inc. I appreciate the opportunity to submit testimony to the Committee regarding H.R. 3110. Public Financial Management, Inc. is an independent financial advisory firm that assists state and local governments in the development and implementation of financing programs. The firm represents clients throughout the United States. Public Financial Management is currently advising on tax exempt financing programs exceeding six billion dollars. One of the major areas of specialization within the firm is financings for energy and utility projects.

Purpose

The purpose of this testimony is to urge that in the Committee's consideration of government leasing, careful consideration be given to the legitimate business relationships between state and lcoal governments and private entrepreneurs. Of particular concern is the tax treatment of facilities owned and operated by taxpayers for the disposal of solid waste. Frequently, these facilities are provided to communities through long term service contracts. Without the availability of the service agreements and the attendant tax benefits to the owners, these facilities, which are vital from an environmental perspective, would often not be provided.

Solid waste projects

The awareness of the desirability of resource recovery projects to process solid waste has vaulted during the past ten years. Problems with landfills were the primary impetus. Landfills became increasingly difficult to site. Concerns over pollution of ground and surface water led to increasingly stringent regulation of landfills by all levels of government. These pollution concerns combined with householders' sensitivities to aesthetics and truck traffic to make the siting of new landfills politically difficult, if not infeasible.

An appreciation of the necessity to conserve energy and natural resources flourished during this same period. Again resource recovery projects became prominent because of the ability to save valuable recyclable materials and to produce steam and electricity from the solid waste steam.

Construction of resource recovery projects to process solid waste has been inhibited by technical complexity. Despite the fifty years of experience in resource recovery in Europe, the projects were novel in the United States. The proven technologies of Europe were available only through license or royalty arrangements. The conventional procurement methods of local governments were inapplicable. The usual detailed design followed by competitive bids prohibited access to the proven technologies and the guarantees of those technologies.

Construction of resource recovery projects was further impeded by financial limitations. The projects are extremely capital intensive. The financing of such a project can increase the debt outstanding of a local government by as much as 50 to 100 percent. The constraints of debt limits and the absence of significant federal funding programs for construction made the financing of resource recovery projects difficult.

One solution to the technical and financial problems discussed above is the use of a "full service contract" (i.e. design, construction and operation). With the service contract, technical risks were mitigated through access to guarantees and procurement constraints were eliminated. Further, the financing obstacles were circumvented by the use of industrial development bond financing by the private sector owner.

The immense capital cost—often hundreds of millions of dollars—to construct such a facility requires that the entrepreneur be guaranteed a prime customer. Without one, the owner cannot make an economic commitment nor will the owner be able to borrow the funds for the financing of such a facility. Typically, such contracts are for the life of the financing—in the range of twenty years.

Specifically, the community enters into a put or pay contract requiring the delivery of certain tonnage of solid waste for a set tipping fee. Frequently, a number of different local governments are involved. In addition to solid waste picked up by the local governments, private haulers bring solid waste to the facility. The owner-operator is permitted to take garbage from other sources to the extent he has excess capacity after servicing the needs of the prime customer. The actual life of the facility will be determined by the normal economics of such facilities. For example, many have operated over forty years abroad. On the other hand, technology may change and the local governments may decide to change to a new type of facility at some time, twenty or thirty years after construction. If the local governments do not own the facility after the initial service contract, the owner-operator must find other customers to utilize it.

Where such a facility is privately owned, the municipality has no control over the facility or its operations other than normal requirements of pollution and other standards applying to private business. It's only right is for damages for failure to perform, and at the end of the initial contract period there is no obligation of the owner to provide a service or of the municipality to utilize the facility.

A municipality owning a facility has control over the facility. It may replace the operator for breach during the initial contract and may enter into a contract with another operator or operate the facility itself after the initial operating contract. Thus, in one case, the municipality owns and controls the facility, except as provided in the operating agreement, and in the other, the facility is owned and controlled privately with a contractual obligation to provide a service. Obviously, there is no depreciation or investment credit available when the municipality owns the facility.

From the owner-operator's standpoint, he is in the business of construction and operating facilities to treat solid waste. His intention is to realize a return on his cost of constructing and return on operating the facility. Thus, he is just like any other taxpayer in a trade or business. He will make a profit or loss depending on his cost of operations and the negotiated fees paid by the municipality. He will pay taxes on any income earned from constructing or operating the facility. The enterprise should not be taxed differently than other enterprises that operate for profit.

The mere fact that a taxpayer provides either goods or services to a tax-exempt entity should not exclude the business from normal depreciation. Obviously, the service fee takes into account existing tax benefits—all charges for goods and services reflect costs and costs obviously include effective tax rates. For certain reasons, debt limits or poor credit availability, local governments may be in the position where private ownership of the solid waste disposal facility is the only option open to them. The reduction of tax benefits to the owner will significantly increase the fees paid by the local government. For example, a solid waste facility costing $100 million would result in a minimum annual fee of approximately $10 million under the present structure of private ownership. The same facility, financed without the availability of tax benefits, could cost the community as much as $5 million more a year.

The purpose of the availability of tax-exempt financing for solid waste facilities is to provide an incentive for these socially desirable projects. Congress has repeatedly determined that these required environmental facilities warrant tax-exempt financing. Such financing is based upon the assumption that the national interest to mitigate environmental damage is served through the tax incentives. Clearly, the combination of lower interest cost and capital recovery does not automatically mean the enterprise is trading on the tax benefits unavailable to the local municipality.

Summary

I am sympathetic with the points raised by the Subcommittee with regard to the abuses of leasing programs. However, I believe the Committee should take great care not to penalize legitimate business concerns that provide vital environmental services to communities. The loss of tax benefits under service agreements to provide expensive facilities for the treatment of solid waste would clearly impede the development of these facilities. Therefore, I urge great care in formulating legislation to ensure that legitimate enterprises contracting with municipal entities not be penalized as a result of the concerns raised at this hearing.

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION

INTRODUCTION

The Public Securities Association is pleased to submit this statement concerning the Governmental Leasing Act of 1983 (H.R. 3110). This broadly phrased bill proposes several notable tax law restrictions in the area of municipal leasing. For example, it would require that property "used by" state and local governments be depreciated using the straight-line method over extended recovery periods and would tighten further the use of investment tax credits for such property. Upon preliminary analysis of this proposal, it appears that it is likely to have wide-ranging and significant implications to the continued use of many valuable forms of state and local government capital raising transactions. Perhaps most unsettling for state and local governments and the investment community is the fact that this legislation has been introduced with a May 23, 1983, effective date.

PSA is the national trade association which represents brokers, dealers, and dealer banks active in the municipal securities market, the U.S. Government and federal agencies securities market, and the mortgage-backed securities market. We currently have nearly 300 member firms whose offices are located in all 50 states. Last year, our members participated in over 95 percent of the dollar volume of new issues of state and local government securities. These same firms also account for the vast majority of secondary market trading activity in municipal securities. Our membership participates in the full range of dealer activities, and includes small firms dealing in special assessment issues and local financings, multi-million dollar investment banking powers, full service national wire houses, major money market center, and regional dealer banks. Member firms serving state and local governments perform a wide variety of financial services, not limited to underwriting of public debt issues. Accordingly, the industry is concerned about any legislative limitation which would appear to impair the ability of states and localities to finance themselves.

PSA OPPOSES RETROACTIVE EFFECTIVE DATE

PSA, has not had time to develop and adopt a specific policy position on the tax law changes embroiled in H.R. 3110, or, more generally on the appropriate role of leasing transactions (e.g., this term is used herein to encompass the more traditional lease/purchase transaction, as well as, lease/tax benefit transactions and other arrangements in which a private entity agrees to provide a public service) in the municipal securities market. We do, however, have a longstanding position in opposition to retroactive Federal legislation. This legislation which, was introduced on May 24, 1983, may not be voted upon until the latter part of the year yet, as noted earlier, would apply to property placed in service after May 23, 1983.

In recent years, the introduction of Federal legislation affecting the municipal securities market with a retroactive effective date has become more common. This practice has a severely unsettling effect on the market because it creates uncertainty for both state and local governments and investors. The result is to increase the costs of all transactions which may be affected by such legislation and to divert attention away from the public policy issues involved in the legislation. Even more fundamentally, PSA believes that retroactive dating of legislation represents an extraordinary application of the legislative process which should only be undertaken in connection with areas clearly requiring immediate legislative action on the part of Congress. In matters involving public finance, retroactive dating of legislative proposals may effectively accomplish, without Congressional consideration or majority vote, the objectives which were sought by the legislation's sponsor or sponsors merely through introduction. The introduction of such proposed legislation usually destroys the ability of state and local governments to carry on the financing programs which such legislation would affect, and, therefore, has serious disruptive effects on the municipal market.

LEGISLATION RAISES MANY SIGNIFICANT PUBLIC POLICY ISSUES

PSA recognizes that the question of the appropriate role of state and local governments in municipal leasing transactions is replete with significant public policy issues. Therefore, we urge the Congress to take a deliberate approach as it reviews and deliberates upon this complex tax law question. The investment community recognizes and appreciates the pressures faced by the Congress to reduce projected Federal budget deficits. However, Congress must not consider this legislation solely in terms of the debate concerning steps to reduce the size of these deficits.

Due to the prevailing concerns regarding deficits, we fear that Congress will consider this legislation with the view that any growth in the use of tax benefit transactions is inherently objectionable. In many respects, growth in the number of municipal leasing transactions may represent merely the natural consequence of other congressional and state legislative actions which have reduced the levels of revenues previously available. Therefore, we believe that the impact of this legislation must be reviewed on its own merits, and carefully analyzed from the point of view of the broad public policy objectives which it seeks to implement. Among the most significant of these public policy issues is the degree of which Congress wants to promote the "privatization" of many of the services heretofore provided by government. We wish to note that this has been one of the frequently stated objectives of this Administration. PSA believes that, in many respects, the use of private sector tax incentives to complement and enhance public sector functions is entirely consistent with the "privatization" effort.

While PSA shares concern with many in Congress about the size of the deficit, we believe that the most prudent approach to our economic situation is adherence to a comprehensive economic development plan whose primary focus should be reducing the rate of growth of federal spending, stable monetary growth, stimulating savings and investment and elimination of unnecessary and burdensome federal regulation.

In reviewing the available public information on this subject, it has become clear that there is very little data concerning the scope and volume of municipal leasing transactions used by state and local governments. It seems particularly inappropriate for the Congress to be considering legislation which, in our judgment, is potentially significant, without any firm statistics regarding the dimensions of its use.

LEGISLATION MAY RESTRICT USE OF EXEMPT-FACILITY IRBS

Despite our limited opportunity to assess the effects of this legislation, it at least appears that its impact would be quite broad. We wish to note that this legislation, among other things, may represent another in a series of attempts to eliminate certain valuable forms of state and local government financings which provide capital to projects which are operated by private entities. More particularly, we are concerned about the potential impact of the proposal on projects financed by exempt facility industrial revenue bonds. PSA would be concerned to the extent such restrictions would effectively eliminate the ability of state and local governments to raise capital to finance traditional public purpose municipal revenue bond facilities such as airports, port facilities, convention centers and public power facilities.

Today, municipal financing for such projects is essential for the construction or redevelopment of infrastructure and facilities necessary for the social and economic well-being of all citizens. The fact that private parties may operate or otherwise benefit from these facilities simply reflects the historic practice of state and local governments in providing public works necessary to support and maintain residential communities and commercial and industrical development.

Last year, after much public debate, the Congress imposed new limitations on small-issue IRBs. The consensus necessary for adoption for this legislation was slow in developing. Implicit in last year's debates concerning small-issue IRBs, and, indeed implicit in Congress' decision to limit restrictions merely to the small-issue area, was a recognition of the very valuable role of other forms of tax-exempt bonds in achieving public purpose and benefit. PSA believes that these bonds have been used consistent with the mandate provided by Congress in the original industrial development bond law passed in 1968.

MUNICIPAL LEASING TRANSACTIONS ARE NOT FREE OF MARKET IMPOSED LIMITATIONS

The published remarks which accompanied the introduction of H.R. 3110 raise another point concerning the "circumvention" of the traditional state and local government debt issuance approval process which we believe requires clarification. It has been suggested that municipal leases or similar arrangements may lead to the undertaking of projects which could not be bond financed because of voter disapproval or limits on indebtedness. We wish to point out, however, that state and local governments participating in these transactions are subject to the same market restraints as arise in connection with typical bond financing.

Appropriations of state and local governments for payment in connection with municipally leased property are made annually and generally represent an operating budget expenditure. Lease/purchases tend to represent more essential type equipment and property, to ensure annual re-appropriation.

We also wish to point out that this form of transaction inherently involves the same type of credit considerations as exist in other forms of municipal finance. Although this form of transaction may not be subject to debt limit restrictions, the creditworthiness of the state or local government issuer remains a critically important consideration. For example, as a participant in this type of transaction, one would certainly want to know the operations budget (deficit) projections of the municipal user. Therefore, it is not likely that we will witness profligate uses of this form of transaction.

Moreover, in the municipal lease/tax benefit transaction, the obligation of the state or local governments is typically viewed as debt, under state law. The negotiated contract terms in such transactions generally impose a promise by the issuer, in advance, to make payment beyond the current appropriations. Such obligation is therefore considered debt, and is subject to the same debt approval process as that which exists in connection with issuing municipal bonds. In addition, the credit analysis undertaken by the investor is the same as that arising in connection with the purchase of municipals bonds. Finally, we note that, in most instances, the level of due diligence review and the number of tax opinions issued are at least as numerous as those typically issued in connection with municipal bonds.

MANY RESTRICTIONS ALREADY EXIST IN THIS AREA

In response to the adoption in 1981 of the safe harbor leasing provisions of section 168 of the Internal Revenue Code, many state and local governmental entities have become increasingly aware of the value tax benefits can provide in the generation of capital. While the use of municipal leasing and other tax benefit transactions are not entirely new phenomena, the publicity following the enactment of the Economic Recovery Tax Act has encouraged state and local governments to reexamine the role that such transactions may play in providing vital services to their citizenry. Congress must recognize, however, in reviewing this matter, that a large number of restrictions have already been included in the Tax Code which significantly limit state and local government use of tax benefit transactions.

It seems appropriate at this time to review some of the most significant of these limitations. As mentioned earlier, H.R. 3110 would require in certain cases that depreciation deductions for property used by tax-exempt entities, e.g., state and local governments, be computed by using the straight-line method over extended recovery periods. However, the ability to recover the cost of property on an accelerated basis under ACRS is limited in cases in which property is the subject of a safe harbor lease transaction entered into after July 1, 1982, or is financed with the proceeds of certain tax-exempt industrial revenue bonds and placed in service after December 31, 1982. The cost of safe harbor leased property (other that mass commuting vehicles and certain transition property) must be recovered over a slightly extended period of time. The cost of property financed with certain IRBs must be recovered on a straight-line basis over the ACRS life.

There are also significant limitations on the ability of state and local government use of investment tax credits and energy tax credits. Section 38 of the Code provides for the allowance of a credit (ITC) directly against tax liabiltiy for an investment by a taxpayer in certain recovery property and certain other depreciable property. Notable among the exclusions from the definitions of section 38 is ". . . property used by the United States, any State or political subdivision thereof . . . or any agency or instrumentality of any of the foregoing." The Treasury regulations already interpret the language "property used by" in this exclusion to mean "property leased to any such governmental unit." It should be noted that this exclusion for property used by a governmental entity is equally applicable to the energy tax credit (ETC). Moreover, in the event that 100 percent of the cost of "energy property" is provided with the proceeds of IRB's, existing tax law restrictions and Treasury regulations would preclude the use of an ETC.

The Code also provides for a special rehabilitation investment tax credit in connection with the rehabilitation of certain qualified real estate. Unlike the ITC, and ETC, this credit is available with respect to buildings leased to governmental unit or tax-exempt entity. However, it should be noted that this credit may be taken only in lieu of both the ITC and the ETC. Moreover, in determining the amount of "qualified rehabilitation expenditures" the cost of acquiring the building and costs of enlarging it are specifically excluded. Finally, it should be noted that the Code and Treasury regulations already require that no expenditures on rehabilitation will be qualified unless the taxpayer elects to use the straight-line method of recovery rather than the normal ACRS method.

In examining the propriety of this legislation it is important for the Congress to recognize that, in order for the lessor in a straightlease transaction or the purchaser-lessor in a sale-leaseback transaction to be able to claim the tax benefits associated with ownership of the property, the tax code and the Treasury regulations already require that the transaction is considered a financing arrangement and the lessor will be viewed merely as a lender and thus not entitled to claim any tax benefits.

CONCLUSION

In closing, we again caution the Congress against taking any hasty action in this area. PSA believes that an accurate and complete examination of the issues involved cannot take place given the information concerning these transactions which is presently available. Even more importantly, we believe the public policy issues involved are both significant and complex and consequently require thorough debate and consideration.

Finally, we would like to reiterate our strong objection to the retroactive effective date contained in this legislation. The planning and approval process for many of the projects affected by this legislation may take up to one year or more to complete. Therefore, merely from a standpoint of equity, it is particularly damaging and unfair to impose the limitations being proposed by H.R. 3110 on these projects which are already well into the planning and development pipelines.

STATEMENT OF MAYOR ARTHUR P. LACROIX, CITY OF RAPID CITY, S. DAK.

It is not my intention to address, on behalf of the citizens of Rapid City, South Dakota, the merits of governmental sale-leaseback financing in general or the technical provisions of H.R. 3110 in particular. Rather, I am concerned with the manner and timing of the Bill's implementation should it be enacted into law by the Congress.

Rapid City is a major regional tourism center whose economy is significantly affected by the volume of tourist trade. Our Rushmore Plaza Civic Center plays a key role in attracting people to visit Rapid City. Concerts, plays, exhibitions, athletic events, trade shows and conventions, all staged in the civic center facility, draw attendance from North and South Dakota, Nebraska, Wyoming, and Montana.

Approximately two years ago, planning was begun for a major expansion of the civic center facility, in an effort to broaden its functional capabilities and enable it to compete more effectively with other regional convention/tourism centers. Engineering and design work for the project was begun in the fall of 1982. Bids have already been let for site preparation work and certain interior renovation work, both of which will commence within the next few weeks. At present, all aspects of the expansion project have been designed around the sale-leaseback method of financing. Only by combining public and private capital can the City afford to make all the improvements which we believe are so important to sustain the magnitude of the civic center's contribution to our local economy.

We are advised by the underwriters retained by our civic center board that the bond sale for the project will occur in August, 1983. (The Inducement Resolution for the bonds was adopted by the City Council of Rapid City on Friday, May 31, 1983.) Under South Dakota law, actual issuance of the bonds cannot occur for twenty days following the sale. As a result, final closing of the financing is expected to occur in early September. At the date of this statement, the project is on schedule in all respects.

Rapid City has relied very heavily on the availability of sale-leaseback financing to bring the civic center expansion project to fruition. If H.R. 3110 were made applicable to this project, not only would the City be forced to substantially reduce the extent of the improvements, but large out-of-pocket costs and hundreds of work hours already invested in the project would be wasted.

For these reasons, it is vital to Rapid City that H.R. 3110, or any similar legislation affecting sale-leaseback financing, contain transitional rules so as to permit completion of projects like ours in Rapid City. Also, because time is so critical to our efforts, we must know at the earliest possible date whether any legislation ultimately enacted will be written so as to accommodate our special needs. Attached to this statement is draft transitional language which our bond counsel advises us would satisfy our needs.

On behalf of the citizens of Rapid City, I thank you for your attention to these special circumstances.

TRANSITIONAL PROVISIONS

(d) Effective dates

(1) In general.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to property placed in service by the taxpayer after May 23, 1983, in taxable years ending after such date.

(2) Binding contracts.—The amendments made by this section shall not apply with respect to any property used by a tax-exempt entity if such use is pursuant to one or more written binding contracts which on September 30, 1983

(A) required the taxpayer (or its predecessor in interest in the contract or contracts) to acquire, construct, or rehabilitate such property,

(B) entitled the tax-exempt entity (or a related entity) to use such property, and

(C) were entered into pursuant to a resolution or other official action taken by the governing body of the tax-exempt entity or before August 1, 1983, indicating an intent to enter into a contract or contracts providing for such acquisition, construction or rehabilitation and use.

In the case of any property used by the United States or an agency or instrumentality thereof, the preceding sentence shall apply only if such property is placed in service by the taxpayer before January 1, 1984.

(3) (No change)

The new language is in paragraph (2) above and is based upon the approach to the effective date question adopted by Congress in Public Law 90-364 and Public Law 95-499, as well as the provisions of Section 103(b) of the Internal Revenue Code and the regulations adopted thereunder.

SMITH & LOVELESS, INC.,
Lenexa, Kans., June 6, 1983.

JOHN J. SALMON,
Chief Counsel,
Washington, D.C.

Subject: Governmental Leasing Act of 1983.

DEAR MR. SALMON: It has been brought to my attention that H.R. 3110, Governmental Leasing Act of 1983, if enacted as proposed could have a disastrous effect on the federal budget, and an even more disastrous effect on the state and municipal budgets.

Congressman Pickle's remarks in the Congressional Record of May 24, 1983, (E2513) do raise some legitimate concerns. That is, governmental use of leasing as an off-line budget ploy to hide capital expenditures is a point well made. The simple solution is to require the governmental entity to capitalize the lease payments to the extent of the lease term, and include such capitalization as a line item in the budget. I believe that this will disclose the extent of the governmental spending.

There is substantial evidence that the use of private-sector funding, with the ability of the private sector to use depreciation and investment tax credits, is at a lower cost to the taxpayer than if the total amount of the purchase were to be funded through municipal or treasury borrowings. The fact also remains that if the private investor sells his interest in the lease to recover his capital, at that time he is subject to the recapture tax generated through the return of depreciated capital.

If the United States Treasury was on a purely positive cash flow basis and did not have to borrow money to support the current or past debt, then perhaps some of the intent of H.R. 3110 would be valid. The United States is faced with the Herculean task of having to maintain and rebuild its present infrastructure and still provide for a defense budget and the necessary social programs which have made our country the envy of the world. At the same time, we must continue to balance the tax burden on companies and individuals so that it does not stifle our economic recovery. The question, therefore, is where will the money come from? The hundreds of billions of dollars necessary just for the infrastructure alone is perplexing. Can the federal budget fund these programs? Can the states fund them from the normal tax revenues? The answer is no.

Governmental leasing, in conjuction with industrial revenue bonds, depreciation and investment tax credits, is an economical way to provide this source of funds to help the public sector. True, the private investor groups will benefit, but so will the public sector. Currently, there are oil and gas shelters, real estate shelters, to name a few. Does the public sector share in this benefit? The answer, of course, is not directly.

I would recommend that you read some of Mr. Harry Goldman's, of Arthur Young & Company, studies on this subject. I believe that his cost figures will be enlightening.

I therefore request that you consider these points in regard to H.R 3110 as it is currently structured.

Respectfully submitted.

ROBERT L. REBORI, *President.*

STATEMENT OF DAVID BROOKS, VICE PRESIDENT, SOUTHERN HOTEL & DEVELOPMENT CO., COLUMBUS, OHIO

My name is David Brooks and I am Vice-President of the Southern Hotel Development Company. We have been trying for over a year to rehabilitate the Great Southern Hotel and Theater in Columbus, Ohio. This property is on the National Register of Historic places and is the largest and most significant rehabilitation project currently underway in Columbus. Although we have spent over $2,000,000 on this project, the entire project has effectively been stopped by the introduction of H.R. 3110.

Our project does not involve a sale-leaseback with a government or other tax-exempt entity. Our concern with H.R. 3110 is solely with § 1(c) dealing with the rehabilitation credit available to privately owned and operated historic structures. In order for you to understand the kind of impact the introduction of this bill has had, I would like to describe the specific project in which I have been involved for over a year and which is now in great danger.

The Southern Hotel and Theater were built in the 1890's. At the time the hotel was opened it was the finest hotel in downtown Columbus. The Southern Theater was for many years the leading theater in Columbus.

Over the last ten years all of the other leading older downtown hotels in Columbus and all of the other legitimate theaters have been torn down. Only the Southern Hotel and Theater remain. However, both of them were closed at the time we bought them.

The Southern Hotel and Theater stand in a particularly critical spot in terms of Columbus' downtown development. They are immediately across the street from a three square block area which has been designated the Capitol South community urban redevelopment area. In that area the City of Columbus has spent over $30,000,000 for land assembly.

I can best give you an idea of the importance of the Southern Hotel and Theater by describing the neighborhood. The Hotel fronts on South High Street in Columbus. South of the Hotel is the new County Court House complex and a series of buildings which have been restored in the last few years. Three blocks north of the Hotel is the State Capitol Building.

The intervening three blocks make up the Capitol South project. Along High Street there is currently a string of deteriorated and mostly vacant buildings or surface parking lots. The only development that has taken place on High Street is a public park and skating rink which was constructed with funds from the Economic Development Administration.

Capitol South Community Urban Redevelopment Corporation has ambitious plans for the redevelopment of the area. However, a major problem today is that there is little pedestrian traffic during the day and virtually no traffic at night. If we are able to proceed with the development of the Southern Hotel and Theater it will serve as a major anchor for the Capitol South project both during the day and at night. If we are not able to proceed with our plans, it will simply be more evidence of the frustration and difficulty of attempting to generate a development in a downtown area.

In order to proceed, the Southern Hotel and Theater project must utilize both industrial revenue bonds and the tax credits available for rehabilitation of a building on the National Register of Historic Places. Even with both of those programs, this has been a difficult and frustrating project to assemble. Since the Hotel and Theater are located in an area in which there is little existing traffic, it has required assembly of a consortium of local banks to fund the industrial revenue bond loan. If tax-exempt financing were not available, the interest rates which the banks would have to charge for this type of loan would make the economic projections very unattractive. Even with industrial revenue bond financing, we do not project any cash flow for the limited partners during the first two eyars of the project and only about $25,000 per year thereafter. Since this project requires cash equity from the limited partners in the amcunt of $2,970,000, the return would be completely unsatisfactory in the absence of the investment tax credits.

The financial feasibility of this project is so difficult, in fact, that the utilization of both industrial revenue bonds and investment tax credits do not make this project sufficiently attractive to let us obtain all of the necessary capital. As a result, the City of Columbus had also applied for an Urban Development Action Grant which would be loaned to this project. One of the results of that application is that there will be close scrutiny of this project, its impact on the community and its financing, at both the municipal and federal level.

The rehabilitation of the Hotel has already been reviewed by the public body responsible for approving the issuance of industrial revenue bonds by the State of Ohio and an inducement resolution has been adopted. However, the size and scope of the project have increased since the adoption of the inducement resolution so as to inclued the Theater as well as the Hotel. In addition, since we are in the process of reorganizing as a limited partnership and admitting new partners, the identity of the borrower may also have changed. As a result, we were in the process of seeking a new inducement resolution or an amendment to the existing inducement resolution which could have been completed in June, 1983.

During our efforts to place the bonds, restructure the partnership, and reappear before the bond authority, H.R. 3110 was introduced into the House Ways and Means Committee which would eliminate the availability of tax credits for this rehabilitation project if industrial revenue bonds are used. As presently drafted, the new law would apply to properties placed in service after May 23, 1983, and there are no transitional rules.

The addition of a transitional rule would solve the problem we face with respect to this project. However, for the reasons stated above, a transitional rule which applies a change in the law to projects which receive the bond inducement resolution after May 23, 1983, would probably not save this project from the change in the law. Indeed, because it is very common for rehabilitation projects to require months, and sometimes years, of engineering and study before proceeding with an inducement resolution for industrial revenue bond project, we believe that a transitional rule which excluded from the operation of H.R. 3110 only projects induced prior to May 23, 1983, would be inherently unfair. It would certainly be extraordinarily unfair in the case of our project.

We respectfully suggest that the problem with H.R. 3110 is not with the transitional rule but with the basic concept of excluding privately owned and privately operated rehabilitations of historic buildings from use of industrial revenue bonds.

If the bill is passed, a private developer would have to compare and weigh the cost of rehabilitating an existing structure with the cost of demolishing such structure followed by new construction. His decision would be influenced by the following tax alternatives:

Rehabilitation

(1) Conventional financing, 15 year straigt line depreciation, and 20 percent or 25 percent rehabilitation credit (the latter available for certified historic structures), or

(2) Industrial development bond financing and 15 year straight line depreciation (unless the project is financed in part by an urban development action grant whereby ACRS depreciation would remain available.)

New construction

(1) Conventional financing, and ACRS under the regulatory tables, or

(2) Industrial development bond financing and 15 year straight line depreciation (unless the project is financed in part by an urban development action grant whereby ACRS depreciation would remain available).

In comparing the alternatives in paragraphs 1 above, one could reasonably conclude that rehabilitation is given a preference. Although the economic benefit of the tax credit must be reduced by the loss of ACRS, there remains some incentive because of the tax credits that are available to rehabilitate rather than demolish older buildings. However, if industrial revenue bond financing is used, there is no incentive to rehabilitate older buildings including those of historical significance. This serves as a disincentive to rehabilitate because of the increased costs involved.

Passage of H.R. 3110 in its present form would be a reversal of Congressional policy that has evolved since 1976 favoring the rehabilitation of older structures, particularly historical structures. Such a policy change would cripple not only efforts to preserve our national heritage but also would be a step backwards in efforts to revitalize deteriorating, decaying or distressed areas which are primarily those found in our inner cities.

All published information including summaries of H.R. 3110 and testimony before Congressional Committees have addressed only the first aspect of the bill, i.e., the sale leaseback. None have mentioned the loss of rehabilitation credits if industrial development bond financing is used. There appears to be no particular abusive situation (such as the Navy's leasing of ships in the sale leaseback context) which the sponsor of the bill is concerned. The policy of the tax credit amendment appears to be one that is directed against using multiple tax benefits. Such a policy could only be implemented at the expense of eroding the other strong Congressional policies mentioned above. As such, the proposal is overreaching in effect and should be limited to such sale-leaseback situations as are abusive.

DEVELOPMENT OF CONGRESSIONAL TAX POLICY SUPPORTING REHABILITATION OF HISTORICAL STRUCTURES

Prior to 1976, the tax laws served as a disincentive to rehabilitate historical and other older structures. New construction was eligible for accelerated depreciation, i.e., 150 percent or 200 percent declining balance methods, whereas used properties including improvements thereto were relegated to either straight line depreciation or, at most, a 125 percent declining balance method. Since 1976, Congress has consistently provided tax incentives for rehabilitation:

Tax Reform Act of 1976

As an incentive, Section 167(o) provided that substantially rehabilitated property could be amortized over 60 months. As a disincentive, Section 167(n) provided that no accelerated depreciation method could be used on property, including new property, constructed on a site formerly occupied by a certified historical structure.

Revenue Act of 1978

Section 48(g) provided a 10 percent rehabilitation credit for a qualified rehabilitation expenditure made to a building that was at least 20 years old, or to a building which at least 20 years had elapsed since the last rehabilitation. By regulation, a taxpayer could choose between the 60 month amortization and the 10 percent credit.

Economic Recovery Tax Act of 1981

Section 46(a)(2)(F) provided a three tier level of credits for 30 year old (15 percent, 40 year old (20 percent), and historical structures (25 percent). To obtain the credit, the taxpayer was required to elect 15 year straight line depreciation. As such, ACRS depreciation under the regulatory tables was not available.

Tax Equity and Fiscal Responsibility Act of 1982

No changes were made affecting the tax credits for rehabilitation expenditures. Section 168 was amended to require the use of 15 year straight line depreciation for property financed with the proceeds of industrial revenue bonds. An exception to this limitation was made to any facility for which there was an urban development action grant issued pursuant to Section 119 of the Housing and Community Development Act of 1974.

Legislative history clearly sets forth the Congressional policy behind these tax incentives. The Joint Committee Report for the Tax Reform Act of 1976 stated that "the preservation of historic structures and neighborhoods is an important national goal. . . . Tax considerations have an important bearing on whether private interests are willing to maintain and rehabilitate historic structures rather than allow them to deteriorate or replace them with new buildings." Prior to 1978, tax credits had been limited to purchases of machinery and equipment. In 1962, when tax credits first became part of the tax law, the Congressional concern was that the average age of domestic manchinery and equipment was greater than those in foreign facilities. Congress, as stated in House Report No. 95-1445, had that same concern "for older buildings throughout the country, primarily in central cities and older neighborhoods of all communities." The purpose of the credit was to "enable business to rehabilitate and modernize existing structures. This change in the investment tax credit should promote greater stability in the economic vitality of areas that have been developing into decaying areas."

In 1981, Congress placed a high priority on capital formation in 1981 under the Economic Recovery Tax Act of 1981. As a result of ACRS depreciation, Congress recognized that there could again be a disincentive to rehabilitate and modernize older depreciable structures. As such, the investment tax credits for rehabilitations expenditures were increased to the current 20 percent and 25 percent levels. The General Explanation of this Act states as follows:

"Investments in new structures and new locations do not necessarily promote economic recovery if they are at the expense of older structures, neighborhoods, and regions. A new structure with new equipment may add little to capital formation or productivity if it simply replaces an existing plant in an older structure in which the new equipment could have been installed. Furthermore, the relocation of a business can result in substantial hardship for individuals and communities. Since this hardship does not affect the profitability of the business, it may not have been fully taken into account in the decision to relocate, even though it is an economic detriment to the society as a whole.

"Accordingly, the increased credit for rehabilitation expenditures is intended to help revitalize the economic prospects of older locations and prevent the decay and deterioration of distressed economic areas."

Thus, the current level of credits, i.e., 20 percent and 25 percent, were recognized as necessary incentives for rehabilitation. These credits were not modified in the Tax Equity and Fiscal Responsibility Act of 1982.

TAX POLICY AND THE HOUSING AND COMMUNITY DEVELOPMENT ACT OF 1974

This Act was Congress' response to the nation's critical social, economic, and environmental problems of the nation's cities arising from the concentration of persons of lower income in the central cities, inadequate public and private investment, and the lack of reinvestment in housing and other physical facilities resulting in urban slums. Consistent with this primary objective of developing viable urban communities is the "support of community development activities which are directed toward the following specific objectives—(1) the restoration and preservation of properties of special value for historic architectural, or esthetic reasons . . ."

Congress has supported and enhanced these policies in the tax laws. Generally, industrial revenue bonds can be issued for capital expenditures up to $10,000,000 under Section 103(b)(6)(D). However, if an urban development action grant has been made as a part of the project, under Section 103(b)(6)(I), capital expenditures of up to $20,000,000 can be taken into account in the issuance of industrial development bonds.

In addition, under the Tax Equity and Fiscal Responsibility Act of 1982, Section 168 was amended to require 15 years straight line depreciation on buildings financed with the proceeds of industrial revenue bonds. However, this limitation does not apply if an urban development action grant has been made a part of the project. The House Report on this change states:

"Congress also was concerned with the combined subsidies provided for investment from the rules for accelerated cost recovery, investment tax credit, and tax-exempt financing. In most cases, Congress believed that the combined subsidies were too generous and that new restrictions in cost recovery deductions taken by private taxpayers for property financed by IDB's were necessary. Therefore, the Act requires taxpayers to choose between (1) ACRS and conventional financing and (2) tax-exempt financing and a slower rate of cost recovery than that provided by ACRS. Congress did not believe such a requirement would reduce the use of IDB's in appropriate circumstances, but would simply eliminate an unnecessary portion of the total subsidy available to the user of the bond proceeds.

"However, Congress believed the extraordinary levels of subsidy are necessary in the case of certain types of property. In those cases, both tax-exempt financing and the full ACRS deductions are made available. Congress believed that additional levels of subsidy are appropriate for low income rental facilities, air or water pollution control facilities installed in existing plants, *and projects financed in part with a UDAG grant.*" (emphasis added).

Thus, Congress, as recently as 1982, recognized that the social policies underlying the Community Development Act of 1974 were consistent with historic preservation.

COMMENTS AND SUGGESTED CHANGES TO H.R. 3110

H.R. 3110 as presently drafted is a significant departure from prior Congressional policy. Tax incentives for the preservation of historic structures and community redevelopment should not be curtailed in any way. There is no abuse in the use of industrial revenue bond financing in conjunction with the availablility of tax credits for these purposes. To the contrary, it is essential for the continuation and enhancement of this type of development.

H.R. 3110 should be amended to limit the application of its provisions only to such sale-leaseback situations as are abusive. Exhibit A is suggested to accomplish this purpose. In the alternative, if Congress decides to restrict tax credits, an exception should be made for those projects receiving urban development action grants. Exhibit B is suggested to accomplish this purpose. Finally, if neither of the above suggestions are acceptable, a clear transitional rule is necessary to exclude those projects for which rehabilitation has commenced and which have relied upon obtaining industrial development bond financing. Exhibit C is suggested for this purpose.

We believe that the project in which we have been involved is a clear example of the type of central city project which Congress has consistently supported in the development of its tax policy and in the Housing and Community Development Act of 1974. H.R. 3110 would mark an abrupt and traumatic change in that policy. It would mean the loss in our central cities of many historic and valuable buildings. In our case, it would mean that an 1896 Hotel and Theater of tremendous public significance to the development of downtown Columbus would suddenly be put in the position of enjoying no advantage over new construction taking place in the suburbs. Under those circumstances, we believe that projects such as ours cannot compete successfully and that the Congressional policy in support of historic preservation which has developed over the last several years will be effectively reversed.

[Exhibit A]

LANGUAGE LIMITING RESTRICTIONS ON USE OF REHABILITATION CREDITS TO SALES-LEASEBACK TRANSACTIONS

Subsection (c) of draft bill H.R. 3110 is amended to read as follows by adding the italic language.

(c) REHABILITATION CREDIT NOT TO APPLY TO *CERTAIN* EXPENDITURES FINANCED BY TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS.—

(1) IN GENERAL.—Subparagraph (B) of Section 48(g)(2) of such Code (relating to certain expenditures not treated as qualified rehabilitation expenditures) is amended by adding at the end thereof the following new clause:

"(vi) TAX EXEMPT FINANCING.—Any expenditures in connection with the rehabilitation of a building *which are made with respect to tax-exempt use property within the meaning of section 168(f)(13)(C)* if any portion of—

"(I) the cost of acquiring such building or any interest therein, or

"(II) the expenditures in connection with such rehabilitation, is financed (directly or indirectly) by the proceeds of an industrial development bond within the meaning of section 103(b)(2)) the interest on which is exempt from taxation under section 103(a)."

[Exhibit B]

LANGUAGE PROVIDING AN EXCEPTION FOR PROJECTS INVOLVING URBAN DEVELOPMENT ACTION GRANTS

Subsection (d) of draft bill H.R. 3110 is amended by adding the following paragraph (4) at the end thereof:

"(4) Notwithstanding anything to the contrary, the amendments made by section (c) hereof shall not apply in the case of any industrial development bond if substantially all of the proceeds are used to provide facilities with respect to which an urban development action grant has been made under Section 119 of the Housing and Community Development Act of 1974."

[Exhibit C]

LANGUAGE PROVIDING FOR A TRANSITIONAL RULE FOR PROJECTS PRESENTLY UNDERWAY

Subsection (d) of draft bill H.R. 3110 is amended by adding the following paragraph (4) at the end thereof:

"(4) Notwithstanding anything to the contrary, the amendments made by section (c) hereof shall not apply with respect to any building—

"(i) the rehabilitation of which began before May 23, 1983, or

"(ii) with respect to which a binding agreement to incur significant expenditures was entered into before May 23, 1983."

Vorys, Sater, Seymour and Pease

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By Hand

June 8, 1983

Hon. Chalmers P. Wylie
2310 Rayburn Building
Washington, D.C. 20515

Re: H.R. 3110 -- Adverse Impact Upon Historic Preservation

Dear Congressman Wylie:

Pursuant to your recent telephone conversation with Mary Bishop, Scott Whitlock, and Larry Fisher, I am sending herewith testimony by David Brooks, Vice President of the Southern Hotel Development Company in Columbus, Ohio, in opposition to section 1(c) of H.R. 3110.

Briefly stated, the elimination of rehabilitation tax credits where industrial development bond financing is utilized, which elimination is provided for in section 1(c) of a bill that otherwise concerns itself with problems associated with certain sale and leaseback transactions, would deal a crippling blow to the ability to finance urban redevelopment and historic preservation projects in Columbus and throughout the United States. Similar concern was expressed by Congressman Moakley of Massachusetts, on page 6 of the statement which he submitted to the House Committee on Ways and Means this morning.

Indeed, with respect to Southern's Columbus project (which involves rehabilitation of the Great Southern Hotel and Theater, a property included on the National Register of Historic Places and a project for which over $2,000,000 has already been spent) the very existence of section 1(c), even though it has not been enacted, has effectively stopped the entire project.

We respectfully submit it is imperative that (1) section 1(c) be amended to eliminate its devastating impact upon historic structure rehabilitation and urban redevelopment, and (2) the sponsors of H.R. 3110, and of any companion Senate bill which may be introduced, promptly announce their intent to so amend section 1(c), the impact of which surely was not apparent to the sponsors of what is principally a bill to address sale-leaseback transactions. Specific amendments are discussed on page 12 and in Exhibits A, B, and C of Mr. Brooks' testimony.

As you are aware, representatives of the Southern Hotel and Theater project in Columbus were authorized to submit written testimony to the House Committee on Ways and Means, but, because of the Committee's limited hearing time, were not permitted to address the Committee at today's hearing.

It is my understanding that you have kindly offered to distribute Mr. Brooks' testimony to Senators Dole and Metzenbaum (who may soon introduce a companion bill to H.R. 3110), to Congressman Gradison (who currently is a co-sponsor of H.R. 3110), and to the remaining members of the House Committee on Ways and Means. If you determine that it would be useful, please feel free to include copies of our letter to you, along with such cover letter as you deem appropriate. One hundred copies of Mr. Brooks' testimony, and of our letter to you, are being provided with this letter for purposes of distribution.

We are most appreciative of your willingness to assist us in our efforts to explain to the Congress that section 1(c) of H.R. 3110, as currently drafted, would deal a crippling and, we are confident, unintended blow to urban redevelopment and historic preservation efforts currently underway and yet to be initiated in Ohio and throughout the United States.

Very truly yours,

John W. Wilmer, Jr.

JWW:wo
Enclosure

Sutherland, Asbill & Brennan,
Washington, D.C., June 10, 1983.

John J. Salmon, Esq.
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Mr. Salmon: We are writing on behalf of more than 400 Production Credit Associations in the Farm Credit System to comment on H.R. 3110, introduced by Representative J.J. Pickle on May 24, 1983. Production Credit Associations (PACs), chartered by the Farm Credit Administration under the Farm Credit Act of 1933, as amended, are engaged in the business of making short and intermediate term loans and offering related financial services to farmers and ranchers. Notwithstanding their Federal charters and statutory mandate to serve the agricultural sector, PCAs are engaged in wholly commercial pursuits and today are fully subject to Federal and state income taxation. PCAs are concerned, therefore, that legislation directed at curbing what many perceive as abuses associated with the use of leasing arrangements by certain tax-exempt Federal instrumentalities may inadvertantly affect their ability as commercial, taxpaying corporation to claim accelerated cost recovery system (ACRS) deductions and investment tax credits.

Under H.R. 3110 as presently drafted, the proposed limitations on ACRS deductions would apply to "tax-exempt use property" which is defined as any property used by a "tax-exempt entity." A "tax-exempt entity" is further defined to mean, inter alia, "the United States, any state or political subdivision thereof, . . . or any agency or instrumentality of the foregoing." Because section 2.10 of the Farm Credit Act of 1971, 12 U.S.C. § 2091, provides that PCAs are "federally chartered instrumentalities of the United States," a literal application of the proposed legislation would treat these taxable corporations as "tax-exempt entities" and severely limit their ability to enjoy the benefit of accelerated ACRS deductions. A literal reading of section 48(a)(5) of the Code, both in its present form and as amended by the proposed legislation, would similarly deny investment tax credits to PCAs with respect to property utilized in their commercial operations. For the reasons set forth below, we do not believe such an anomalous result is either intended or warranted.

The foundation for the proposed legislation was laid at the public hearings conducted by the Subcommittee on Oversight on February 28 which focused on the charter leasing arrangements entered into by the Department of the Navy for certain ships. We have carefully reviewed the testimony offered at this hearing as well as the staff reports which have dealt with the issues raised by such leasing arrangements. Our review did not disclose a single instance where concern was expressed with respect to the propriety of tax benefits enjoyed by taxable governmental instrumentalities. Indeed, even a cursory examination of the issues discussed makes it clear that the abuses identified by the Subcommittee and staff were necessarily associated with tax-exempt governmental units.

The report of the Subcommittee on Oversight, after analyzing the Navy leasing arrangements, concludes that the long-term leasing of major assets by the Federal government "is more costly than purchase of the same assets." This is based upon the assumption that the government's cost "consists of rental payments and the revenue loss as a result of net tax benefits available to the lessor." The assumption is a valid one in the case of the Navy and other nontaxable governmental units. It is not valid, however, with respect to PCAs because it fails to take into account the fact that PCAs pay Federal income tax on their earnings, thus offsetting any "Federal cost" associated with their use or ownership of property qualifying for the investment tax credit and ACRS deductions.

Indeed, it is difficult to even think in terms of "Federal cost" in the context of PCA expenditures for depreciable property. PCAs receive no appropriated funds. Funds to support PCA lending operations are borrowed from twelve regional Federal Intermediate Credit Banks (FICBs). The FICBs in turn raise their funds through the issuance of Farm Credit System notes and debentures. These notes and debentures are neither obligations of nor guaranteed by the Federal government. Although the PCAs were initially capitalized by the United States, all government capital has been retired. Today, all the stock of PCAs is owned by their members/borrowers. PCAs are governed by boards of directors elected by such members/borrowers. Like the other lending institutions with which they compete, PCAs are subject to government regulation, and, like such other lenders, PCAs operate with an earnings objective. Because PCAs are cooperative farm credit lenders, their earnings inure to the benefit of their members/borrowers.

In explaining the recommendation that Congress should reexamine cost recovery deductions for lessors who enter into long-term lease transactions or similar arrangements with the Federal government or other nontaxable entities, Subcommittee Chairman Charles B. Rangel notes "that certain leasing arrangements permit tax benefits to flow through to nontaxable entities which are not eligible for them on their own account. This can result in a negative effective tax rate on the assets leased by nontaxable entities. In effect, nontaxable entities through leasing receive the benefits of income tax deductions (and in unusual cases investment tax credits) but, unlike taxable entities, have no corresponding liability to pay income tax." Again, the concern about negative effective tax rates obviously has no application to PCAs, which are fully subject to Federal income taxes on the earnings derived from their lending and service activities.

In this regard, PCAs are in a position similar to that of a tax-exempt charity or government instrumentality which uses property in connection with an unrelated trade or business subject to Federal income tax under section 511 of the Code. Such property is, and under the proposed legislation would continue to be, eligible for the investment tax credit and full ACRS deductions. See Rev. Rul. 82-218, 1982-51 I.R.B. 5 (treating a state university engaged in an unrelated trade or business—i.e. the operation of a commercial television station—as a private entity rather than as a governmental unit or instrumentality for purposes of qualifying property used in such business for the investment tax credit.) It follows a fortiori that PCAs, as fully taxable corporations, should qualify for such tax benefits.

ACRS deductions and the investment tax credit were enacted to stimulate investment by taxpaying corporations. We are aware of no justification for denying such incentives to PCAs merely because they are federally chartered and are denominated "federal instrumentalities" under the Farm Credit Act. We urge, therefore, that the Committee clarify the language of H.R. 3110 in order to make it clear that privately owned and fully taxable government instrumentalities are not to be treated as "tax-exempt entities" for purposes of this legislation.

Sincerely,

MAC ASBILL, Jr.
WARREN N. DAVIS.

STATEMENT OF JOHN BUCKLEY, CITY MANAGER, TROY, N.Y., ON BEHALF OF THE CITY OF TROY

Gentlemen, we oppose section 1(c) of H.R. 3110, which denies the rehabilitation tax credit to projects financed with tax exempt Industrial Development Bonds (IDBs). If passed, this legislation would severely undermine the reconstruction and revitalization of depressed urban areas. Furthermore, the retroactive aspect of section 1(c) H.R. 3110 would harm persons who have already undertaken projects and issued IDBs in the reasonable belief that they would receive the rehabilitation credit.

I. SECTION 1(C) OF H.R. 3110 WILL DISCOURAGE URBAN RENEWAL

The combination of IDB financing and the rehabilitation tax credit is just beginning to effectively spur the redevelopment of older cities. H.R. 3110 will make this combination unavailable. Its passage would be a setback to urban redevelopment.

The suggestion has been made that the combination of IDB financing and rehabilitation tax benefits is an inappropriate "double-dip" into the pocket of the Treasury. This is not so. The conbination of rehabilitation credits and IDBs should not be seen as a "double-dip" since these two tax benefits serve different social goals.[1]

IDBs enable municipalities to encourage development where it is most needed. Use of these bonds is limited to projects that, in the judgment of the municipality, contribute substantially to the public welfare. This judgment is generally based upon a perceived economic benefit to the community, such as the creation of jobs. Recently enacted public approval requirements assure responsible use of these funds.

The tax credit for qualified rehabilitation expenditures serves a separate purpose: the preservation of existing building stock, particularly buildings of historic significance. By making rehabilitation less expensive, historic architeture is saved. As well, rehabilitation prevents the waste of demolition.

A project that accomplishes two different social objectives, both of which benefit the public, should receive the incentives that accompany each purpose. It would be counterproductive to deny one of the incentives, the rehabilitation credit, because the project also benefits the public in a separate way and is therefore entitled to IDB financing. Yet H.R. 3110 would have this effect.

Many of the projects that serve both the purposes of community development and historic preservation are located in the depressed centers of older cities. Hence, these projects have special social value. I would like to cite the City of Troy as an example.

Troy has been listed among the most depressed cities in the country. Recent studies show that 30 percent of the office space in Troy is vacant. Such an economic climate makes it difficult to attact new development. Yet we are fortunate enough to have a developer currently in the process of rehabilitating a large old hotel in the center of town into a modern 60,000 square foot office building. The City has been working for four years to get a developer to take on this project. One developer quit in 1981 because he could not come up with a workable financing package. It was only when the combination of IDB financing and the rehabilitation credit became available that a feasible project was possible. This project—the most important commercial renovation now underway in Troy—would be impossible today if H.R. 3110 were law.

If H.R. 3110 is passed, a developer will be forced to choose between an IDB loan and a rehabilitation credit. In the case of the Troy hotel project, conventional financing was impossible. Surely H.R. 3110 will also make many other projects impractical. The result will be much less construction dedicated to the preservation of existing structures. Why bother with rehabilitation, when new construction is cheaper and qualifies for IDBs? In sum, a workable possibility for the revitalization of decaying cities will be lost.

II. EFFECTIVE DATE

In addition to the future effect H.R. 3110 will have on our older cities, it is unfair to those who have already begun projects under the current law.

As written, H.R. 3110 permits the rehabilitation credit for projects that were financed with IDBs only if they were placed in service by May 23, 1983. It denies the credit to projects which, although not completed by May 23, have already issued IDBs, commenced construction, and leased space. This is unfair.

Again, the Troy hotel project illustrates such a situation. The developers undertook the project under the impression that the rehabilitation credit would offset a portion of their expenses, and that IDB financing would further reduce their cost. The project began in January, IDBs were issued in April, and construction is currently in progress. Using calculations that included the rehabilitation credit and IDB carrying charges, the developers have pre-leased over half the space in the building. If H.R. 3110 is passed, the rug will be pulled from under them. The developers cannot choose to refinance the project with conventional loans. First, conventional loans will likely be unavailable. Second, the IDBs carry a 5 percent redemption penalty. Lastly, a large amount of the IDB funds have already been spent and thus refinancing would not, as the bill is drafted, reinstate the rehabilitation credit.

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[1] In contrast, the combination of the rehabilitation tax credit with a depreciation deduction based on the full rehabilitation cost (without reduction for the credit) was a true "double dip." The tax credit was, in effect, a rebate on the cost, yet depreciation was allowed on the entire cost. The Tax Equity and Fiscal Responsibility Act of 1982 eliminated this "double dip" by reducing the depreciable basis of an asset in the amount of the tax credit taken.

This is the most unfair aspect of H.R. 3110. Projects commenced in good faith under existing law should not be punished.

If section 1(c) of H.R. 3110 is enacted—as I hope it is not—the effective date should only apply to projects where the IDBs are issued after a given effective date.[2]

This is a simple and more equitable rule. It is more similar to the effective date rule for other parts of the bill. H.R. 3110 contains a specific exception for binding contracts made prior to May 23, 1982 if the property is to be used by a tax exempt entity.

If H.R. 3110 is passed, the loss to our older cities will be great. We in Troy have another project—to provide housing—which could be cancelled. Developers in similar positions all over the country may be forced to do the same. Troy and many other cities will have lost a battle in their efforts to become revitalized.

If section 1(c) of H.R. 3110 is not rejected in its entirety, it should at least be amended so as not to be retroactive. In its present form it is unfair to those who have already begun projects and issued IDBs believing they would be entitled to the rehabilitation credit.

WEINTRAUB & KOGAN
Harrisburg, Pa., June 9, 1983.

Re H.R. 3110, 98th Congress, 1st session, tax exempt organization leases.

JOHN J. SALMON, Esq.
Chief Counsel, House Ways and Means Committee,
Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: I am writing this statement for inclusion in the printed record of the hearing on the above bill. For the reasons stated in this letter I request the Committee amend section 103(b)(6)(O)(i) of the Code to eliminate the restriction in the case of National Register buildings, strike section 1(C)(1)(vi) of the Bill to allow simultaneous use of the rehabilitation tax credit and tax exempt financing and to amend section 1(a)(13)(ii) of the Bill to allow the 15 year depreciation schedule for historic properties.

My partner and I are involved in numerous projects involving the adaptive reuse of older buildings, both historic and nonhistoric, in the mid-Atlantic states. While most of our work involves adaptive reuse by private profit making entities, in particular, limited partnerships, a significant number of transactions involve the lease and occupancy by nonprofit organizations. For the benefit of the Committee I want to provide you with a general description of some of the projects we have been involved in and the effect this Bill would have on them.

First, from the outset I want to express my appreciation of the thrust of the Bill, which is to prevent nominal private ownership of public facilities solely for the tax benefits. I think, however, a careful review of the existing abuses would show that the Bill is too broad in scope. Where the proposed tax exempt lessee owned the leased property prior to January 1, 1981 the "anti-churning rule" I.R.C. § 168(e)(B)(ii) would clearly deny the ACRS 15-year depreciation period to the new owner on the existing building. New construction and rehabilitation generate tax revenues for the United States Treasury and should be considered in analyzing the revenue loss from the ACRS depreciation. These new construction/rehabilitation syndications may appear to be paper transactions but if one looks carefully at the various projects the only reason some of the tax exempt organizations involved are prepared to release even nominal control of their key assets is because they need the subsidies provided by the syndication proceeds to make their projects financially feasible.

I realize that from inception of the original sale of tax benefits through leasing provision in the Economic Recovery Tax Act of 1981, the Committee and other members of Congress have been seriously concerned about the potential revenue losses. I think, however, that it is important to distinguish between "paper transactions" where there is merely the nominal transfer of ownership to private organizations and real transactions in which risks are being undertaken by the taxable organizations involved.

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[2] The most recent major change as to IDBs, Section 215(a) of the Tax Equity and Fiscal Responsibility Act of 1982, applies only to IDB obligations issued after December 31, 1982.

With respect to the projects that we have been directly involved in none involve "nominal ownership" by private profit making organizations. In each of these situations that I am involved in there is a real risk the tax exempt lessee will fail to meet its financial obligation so that the for profit organization could end up having to pay the mortgage without a viable tenant. Even as to the art centers and civic auditoriums which seem to be an unfavored use by the Committee there is a real risk to the so-called "nominal" private owner (generally a limited partnership) who leases to the tax exempt organization that such organization will not generate sufficient revenues to pay the debt and the partners, even if the partnership loans are on a nonrecourse basis could lose their equity investment and suffer potential tax benefit recapture.

Another very important economic reason for the Committee to revise its Bill to only address the major abuses is that properties that are leased to tax exempt entities owned by nonexempt entities generally remain on the local real estate tax rolls. A very difficult problem occurs in Capital cities like Harrisburg where as much as 60 percent of the City's potentially taxable downtown properties are on the exempt roll. The passage of this Bill would make it next to impossible for buildings in Harrisburg to be rehabilitated and remain in private hands and on the tax rolls where they are to be occupied by the Commonwealth of Pennsylvania or the many trade organizations that are exempt.

Our rents are not sufficiently high to amortize the cost of rehabilitation without a combination of "tax subsidies". In Harrisburg two major office buildings (the Barto and the State Street Buildings) were rehabilitated and leased to the Commonwealth at an initial base rate of $10.96 per square foot, far below the major city rates of $20.00 per square foot or more. Unfortunately, our construction costs are not much less than the larger city; the loss of the tax benefits will force the Commonwealth to acquire the properties to keep its occupancy costs at this low rate. This would mean that the tax base of the City would be further eroded and thereby requiring further requests for assistance from the federal government.

I know of other projects, particularly large scale housing projects where syndication proceeds have been turned over to nonprofit organizations to create funds for increasing their housing activities. While there may be a great debate between tax subsidies versus direct grant expenditures, I think that the flexibility offered by the tax subsidies has some merit and should not be abolished without careful analysis.

I believe that the Committee, instead of further restricting the use of tax exempt financing in conjunction with the rehabilitation tax credits, should consider reexamining the previously enacted restriction on the use of tax exempt financing for recreation or entertainment, appearing in section 103(b)(6)(0)(i) of the Internal Revenue Code. In Harrisburg, a group of citizens including my partner and I have volunteered hundreds of hours trying to put together a project for the rehabilitation of a historic theater listed on the National Register of Historic Places. As it now stands, the restriction in that provision would prohibit us from using tax exempt financing unless the project foregoes the use of the tax credits and the depreciation by retaining direct ownership in the nonprofit organization. While it is true that several hundred thousand dollars of "tax subsidy" would be available here, much of this subsidy, because of a private placement of partnership interests and contributed legal services, would enure to the benefit of the nonprofit organization rather than provide fees for various intermediaries. This project will have a tremendous effect on the City of Harrisburg because it will add to its nightlife thereby making feasible additional residential units available in the downtown area. It also increases the viability of a new major hotel for which the City is seeking UDAG funding. The City of Harrisburg has suffered over a number of years from the lack of quality nighttime activities. Bringing people downtown increases retail and restaurant sales and makes the office environment more attractive. While there may be some merit to the argument that tax subsidy dollars should not be used for entertainment or recreation, when we consider the direct economic development benefits to the City from having a rehabilitated theater that is financed in part by the tax subsidies, the argument does not appear strong.

Thank you for your consideration.

Sincerely yours,

ARNOLD B. KOGAN.

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